

## Abstract

Social Impact Bonds (SIBs) are a relatively new model for government procurement of publicly funded social services, aiming, among other things, to generate social and economic development for marginalized low-income populations, while saving taxpayer money. This dissertation reviews and critiques the case made by proponents of the SIB model, who point to new resources, efficiency enhancements, and the ability to fund innovative new social programs in a context of austerity. This dissertation systematically summarizes the attributes of the SIB model, its stakeholder participant organizations, and its dissemination to date. We undertake, to our knowledge, the first compilation and analysis of expected and maximum rates of return data on SIBs, significantly expanding the sample size for maximum rates of return, and suggesting these are significantly higher than previously reported. We also undertake a compilation of the limited data on investor repayment, and find, contrary to popular narratives surrounding the high investor risk, that public data suggests SIBs have been repaying investors consistently. These results imply that the new finance alone is not sufficient for SIBs to generate a net benefit for public sector, from a value-for money perspective, relative to conventional procurement. While the SIB model may allow government to initiate social spending that may not have been otherwise possible, this is only due to its ability to exploit government accounting conventions and defer the recording of committed liabilities on public balance sheets, at the expense of higher administrative, transaction and financing costs.

We then construct and evaluate competing theories attempting to explain the rise of SIBs. This includes the development of a conventional model based on principal-agent problems and asymmetric information; however, unlike the few previously published economic models of SIBs, ours explicitly accounts for the structural disadvantages faced and the downside risk facing government. While SIBs fit the logic of orthodox agency theory, which frame such instruments as efficiency-enhancing contract structures, our analysis suggests that the underlying assumptions and requirements for this approach are not self-evident given the nature of public social service delivery. We then outline alternative institutionalist and Marxian-inspired theories of neoliberalism, financialization and the associated reformulation of state activity that more plausibly explain SIB emergence, emphasizing their alignment with the logic and interests of finance and its beneficiaries. We conclude by summarizing our policy and governance recommendations with respect to SIBs and suggest alternative approaches to addressing the social challenges rooted in the growing socioeconomic inequality and precariousness SIBs are designed to address.

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THE POLITICAL ECONOMY OF SOCIAL IMPACT BONDS

by

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*For Larissa*

# Preface

On September 10<sup>th</sup>, 2010, the United Kingdom’s Minister of Justice, Crispin Blunt, visited HM Peterborough prison to announce a new anti-recidivism program. This program was promoted as the first Social Impact Bond project, a new mechanism of delivering prevention-focused social programs based on private sector financing and government repayment, but only in the case of successful outcomes. The Tory minister noted that while the government’s “priorities are to punish offenders, protect the public and provide access to justice.... we want to initiate a more constructive approach to rehabilitation and sentencing, and re-think whether putting more and more people into custody really does make people safer” (Ministry of Justice, 2010). The press release went on to note that “at a time of tight public finances, payment by results models, such as the Social Impact Bond, can tap into new sources of funding to reduce reoffending and provide value for money for the tax payer”. By generating a new financial instrument to draw on potential futures savings of prevention-focused programs, and converting them into working capital and financial profit for investors, a financial innovation was created seemingly well-suited to a context of austerity, high inequality and growing social service pressures.

At the same time, across the Atlantic, the Financial Crisis Inquiry Commission was wrapping up the last leg of its public hearings as part of its mandate to “examine the causes of the current financial and economic crisis in the United States” (2011, p. xi), which by that point had clearly grown into a full-blown global crisis of the scale not seen since the great depression. It had been 24 months earlier

that the key punctuating events of the financial crisis had taken place, with the US government taking over government-sponsored mortgage lenders, Fannie Mae and Freddie Mac on September 7th, 2008, shortly followed within a week by the buyout of Meryl Lynch, the bankruptcy of Lehman Brothers, and the government bailout of AIG, all leading corporation in the global financial industry.

The commission's final report, while identifying multiple sources of systematic failure, placed significant emphasis on the emergence of complex financial instruments and the "dramatic failures of corporate governance and risk management" (p. xviii) within leading financial corporations at the highest level. Goldman Sachs, one of several named, and a subsequent investor and promoter of SIBs in the US and elsewhere, had "been criticized—and sued—for selling its subprime mortgage securities to clients while simultaneously betting against those securities" a practice paralleled to "buying fire insurance on someone else's house and then committing arson" (p. 236). The report tied these unethical practices of financial industry players, and the systematic influence purchased through lobbying expenditures and campaign contributions, to the methodical undermining of the safeguards put in place after the great depression and subsequent efforts designed restrict the very practices that lead to the crisis.

The eventual impact of the crisis, founded on financialization, was intense and wide spread, as highlighted in commission's report.<sup>1</sup> In the US, during the year and half following October 2008, the crisis US, unemployment and underemployment rates more than doubled (pp. 340, 348 & 390). Home prices dropped by 30% (p. 475), with homeowners having to sell their homes at a loss under conditions of extreme hardship, desperation and adversity. Nearly 40% of households surveyed were without work, had underwater mortgages, or were behind in their mortgage obligations in this period (Hurd & Rohwedder, 2010). These results led to widespread pessimism, illustrated poignantly by the additional 4,750 suicides between 2007 and 2012 attributed to the recession (Stuckler & Basu, 2013). The apparent counter-intuitiveness of governments resorting to SIBs, a financialized solution,

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<sup>1</sup> See also Freeman (2010) and Kotz (2017b) for summaries, in addition to references below.



to address growing social service demands, given this context, is an irony which has motivated this study.

Despite the acuteness of the events of 2008-2009, the crisis was only the most dramatic expression of a growing precariousness amongst the less fortunate majority, who in the US for example, had seen stagnant or declining real wage growth going back decades as inequality had continued to increase since the 1970s. Over this period a shift in welfare state administration has taken place in western advanced economies, with a movement towards contracting out paired with a context of resource constraint, limiting non-profit organizations' ability to respond. Despite these challenges, non-profit and community organizations have attempted to meet demands, innovate and expand to take on the increasing roles they have been asked to fill, at times under increasingly restrictive circumstances. As these organizations struggled to meet these challenges, they have developed new operational forms such as social enterprise, cooperative structures to establish an alternative to profit-centered firms and models that have increasingly become common in social service delivery. These organizations who continue to adapt, learn and innovate in how they address social challenges through front line service delivery, and the public servants who continue to support and enable this work despite growing adversity, are a second motivating source for this study. We hope the knowledge uncovered here can help inform and advance the work of these front-line service providers and their supporters who continue to pursue social justice in increasingly turbulent times.

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# INTRODUCTION

The 2008 financial crisis and subsequent impacts generated a dual challenge for national and regional governments in many advanced economies. In the years following the crisis, governments met new populist movements both from the political left and right. On the left this took its most visible form in the Occupy Wall Street movement, defined in opposition to the growing power, influence and wealth of the top one-percent of income earners, generating renewed expectations to deal with the increasingly salient challenges of poverty, wealth concentration and income inequality. From the political right, the Tea Party movement and other voices highly critical of a government captured by elites and calling for austerity, spoke to the growing fiscal challenges of falling government revenues and increasing deficits. In the United States these groups coalesced respectively around the unconventional presidential runs of Bernie Sanders and, to a lesser and more chaotic extent, Donald Trump, with similarly unconventional political developments gaining momentum in other advanced Western economies.

One new policy tool that emerged and spread in the post-crisis period that appeals to both these perspectives and driven by macro-level developments was the Social Impact Bond (SIB; Arena, Bengo, Calderini & Chiodo, 2018; Whitfield, 2015, p. 8). SIBs have grown as an alternative mechanism for government procurement and delivery of social public services, promising, amongst other things, to generate social and economic development for marginalized low-income populations while saving the government money (Gustafsson-Wright, Gardiner & Putcha, 2015). While the scope of the SIB model to date is still limited, with only 100 identified projects up and running as of January 2018 since their introduction in the United Kingdom in 2010, the ambitions of proponents are high, with over one hundred projects in development in the United States alone (Social Finance, 2018). The



qualitative ambitions are equally aspirational, with one proponent expressing the SIB's "promise to transform the social sector into a competitive marketplace that efficiently *produces* poverty reduction" (Galloway, 2013, p. 3).

This dissertation examines SIBs as a new model for delivering social public programs, one that builds on a trend of devolution of public spending authority and an increasing role of non-government entities in the provision of publicly-funded service.<sup>1</sup> The main purpose of this dissertation is to explain how SIBs work and explore their theoretical motivations, providing a foundation for future study of how effective they have been in practice in their short period of existence. Its main interventions will be to systematically summarize the attributes of the SIB model and its dissemination to date; and construct and evaluate competing theories which attempt to explain the rise of SIBs, from orthodox economic theories with an emphasis on principal-agent problems and asymmetric information to Marxian-inspired theories of neoliberalism, financialization and the associated reformulation of state activity. As part of this analysis, we generate new insights based on the limited but still suggestive data available on SIBs projects, challenging some of the assumptions of proponents narratives surrounding the model.

A key characteristic of services procured under an SIB is that they are preventative in nature (Deloitte, 2012; Mulgan, Reeder, Aylott & Bo'sher, 2011), such that their undertaking could preclude the necessity of some future government expenditures arising from formal legal obligations or informal expectations based on precedent. For example, investment in reintegration services for those exiting prison can reduce recidivism rates, in turn reducing future expenditure obligations on law enforcement, the judiciary and prison systems (Lipsey & Cullen, 2007; Warren, 2007). Another example is child welfare services, where investments in income supports, family violence prevention, early social worker intervention, and family reunification, can reduce future expenditure

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<sup>1</sup> McHugh, Sinclair, Roy, Huckfield, and Donaldson (2013), Joy and Shields (2013), Loxley (2013), and Warner (2013) have placed SIBs in a broader context of longer term trends with respect to state retrenchment in direct social service delivery and the more recent fiscal pressures linked back to the 2008 global financial crisis.

requirements associated with child maltreatment and/or placing and maintaining children in the custody of the state.<sup>2</sup> Government-funded investments in early childhood development (Heckman, 2006), active labor market programs (Card, Kluve & Weber, 2010) and disease prevention (Chokshi & Farley, 2012) are all additional cases where effective investments can generate savings for government and may have the potential to generate savings in excess of their costs in present value terms. SIBs are a financial innovation in that they create a formal structure to borrow against these projected social savings, potentially allowing more of these unfunded projects to proceed.

The bundling of social program design, finance and operations into a single outsourced contract between government and the private sector consortium is another defining feature of an SIB. Under an SIB, a government offers to pay an amount to a private sector consortium, with the amount potentially based on the 'costs of doing nothing', to address a social problem manifested in an identified population. The consortium then aims to prevent the realization of the negative social outcome, and in turn the costs identified, through an intervention. These consortiums involve private financiers who may be motivated by corporate social responsibility (CSR) in addition to financial returns (Humphries, 2014), service delivery agencies, and often an intermediary that specializes in the development of the SIBs and manages the project. SIBs then involve privatizing some activity that is ordinarily undertaken by the state in conventional social service delivery, including project design, management and financing. A third defining feature of SIBs is its Pay-by-Results (PbR) structure such that repayment of the investment plus return to the intermediary, and in turn the financiers, is based on clearly articulated targets and arms-length quantitative evaluations. If the consortium does not meet the targets they are not paid or their compensation is scaled based on the degree to which targets are unmet. By design, SIBs have internal evaluation processes to determine whether they are meeting their targeted objectives.<sup>3</sup> However, a systematic academic analysis of SIBs assessing and

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<sup>2</sup> See Fang, Brown, Florence and Mercy (2004) on the social costs of child maltreatment, and Schweitzer, Pecora, Nelson, Walters, & Blythe (2015) on the effectiveness of family preservation programs.

<sup>3</sup> See for example Jolliffe and Hedderman (2014), Disley and Rubin (2014), and Vera Institute for Justice (2015).

comparing them to alternative delivery methods such as public delivery and conventional procurement has yet to be undertaken (Fraser, Tan, Lagarde & Mays, 2018). The presumption in the SIB proponent literature is that governments face systematic challenges in adopting new ideas and producing innovative solutions to social problems (Liebman & Sellman, 2013). SIBs in this view then serve as a mechanism for applying the talents and abilities of the private sector to generate better solutions to social problems (Dubno, Dugger & Smith, 2013).

Proponents point to the potential of SIBs to involve more diverse stakeholders, generate better incentive structures in government service delivery, more efficiently allocate government spending, and promote program innovations, all while shifting risk to the private sector (Fox & Albertson, 2011). Mainstream economists have highlighted that if SIB contracts are to be efficiency-enhancing solutions relative to alternative procurement models, they need to better address principal-agent problems (Pauly & Swanson, 2017; Wong, Ortmann, Motta & Le Zhang, 2016), where hired agents are assumed to put their own interests before those they are hired to serve, which in the presence of asymmetric information provides the opportunity for the agent to take advantage of the principal. This framework has been applied to explain financial innovations analogous to SIBs in applied public finance, such as Public Private Partnerships (PPPs). These models provide an existing theoretical framework in which to formalize supposed government inefficiency as a justification for SIBs.<sup>4</sup>

There are at least five reasons to believe SIBs will continue to grow in number in the medium term. First, unlike views on the waves of privatization that took place in the years following the economic crisis of the 1970s, where there were arguably clearly staked-out positions of the political left and right, SIBs are ideologically ambiguous. Their emphasis on social investment and the power of prevention in generating improved outcomes for the disadvantaged speak to those sympathetic to greater government action to reduce socio-economic inequality. Those more critical of government

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<sup>4</sup> For examples of principal-agent models of PPPs see for example Bennett and Iossa (2006), Hart (2003), Iossa and Martimort (2015), and Martimort and Pouyet (2008).

intervention may appreciate their focus on reducing future government expenditure, greater involvement of the private sector and entrepreneurship, and the high-power incentive structure based on paying only for projects that deliver results and demonstrable future savings. This chameleon-like nature of SIBs makes them a particularly appealing tool for political decision makers seeking reelection. Secondly, the social policy areas in which SIBs are operating, based on survey studies reviewed in Chapter 1, have a high potential to generate not only social benefits from a cost-benefit perspective but also fiscal savings to governments in excess of the cost of programming. This suggests that the universe for which SIBs could potentially be applied on a cost neutral basis is fairly large (however this also true when these same initiatives are directly implemented by government). Thirdly, SIBs to date appear to face particularly favorable treatment under standard accounting principles, such that accounting for the expenditures can be deferred, again making them attractive to decision makers, allowing them to provide incremental funding for social services in a context of fiscal restraint.<sup>5</sup> The fourth reason SIBs are likely to grow in number is the continually expanding set of legislative, financial, and organizational supports that have been established to promote and expand SIBs. Finally, SIBs fit well with current trends in government approaches to economic inequality with emphasis on a laissez-faire approach to labor processes and production, instead of intervening directly to mandate or incentivize stable employment and living wages.<sup>6</sup> More often governments, especially in countries that have been leading in SIB implementation, have continued on a path of growing social public expenditures with a reliance on human capital and redistributive measures as the central tools in addressing inequality, expanding the domain of application of the SIB construct. These all suggest a likelihood that SIBs will continue to proliferate in the near future.

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<sup>5</sup> See Chapter 3, Section I.

<sup>6</sup> In the post-2008-crisis era, despite rising interest in the issue of inequality, there appears to be minimal interest from or insufficient pressure on governments, particularly in the United States and the United Kingdom, to altering the institutional structure of the production as means of addressing income inequality, if one takes trade union density and minimum wage data as indicators. Trade union density decreased on average in OECD countries by 6.1 percent between 2009 and 2013 with decreases the United Kingdom of 6.1% and in the United States of 8.4% (OECD, 2018). The real value of the minimum wage fell 5.5% from 2009 to 2016 in the US in the UK has increased by 1.1% over the same time period (OECD, 2018).

After addressing a number of foundational issues, this dissertation seeks answers to the following questions: First, can the emergence of SIBs be understood as efficiency-enhancing contract structures, founded on optimal contract theory aimed at addressing problems that may arise when agents are hired to undertake tasks to further the interests of principals; and secondly, what are the underlying institutional and behavioral assumptions of this approach, and are they likely to hold in practice? While we find that SIBs can fit into the mold of the principal-agent construct, providing a useful framework for clearly articulating the potential of SIBs, our analysis suggests that the underlying assumptions of the approach are not self-evident, particularly in the context of public social service delivery, creating doubts as to efficiency-based explanations of SIB emergence. Given this, we then pursue alternative explanations. It is argued that to fully understand the emergence of SIBs, one must consider the broader historical context in which they have emerged, the motivations, interests and relative power of stakeholders, including the increasing importance and influence of the financial sector; and further that SIBs are best understood as a logical extension of neoliberal approaches to state governance.

SIBs are a specific and recent finance-based innovation that is part of two broader and evolving consequences of neoliberal economic policy. The first is in government procurement, where the private sector is gaining further responsibility for delivering and financing services that previously had been either delivered directly or managed by government. At a high level, this is part of the familiar pro-privatization stance associated with neoliberal thinking, but is also connected to more nuanced developments over the last forty years with respect to government procurement. While contracting out is a long-standing practice of Anglo-western governments, new tools that became increasingly prominent in the late 1970s and 1980s have seen an ever-evolving transfer of decision making power and responsibility to private sector entities (Salamon & Lund, 1989, p. 8-9). The associated de-unionization and growing precariousness of the workforce, along with new profit-making opportunities for investors, likely contributed to the growing income inequality seen over

this period (Freeman, 2005, p. 137; Gottschalk & Smeeding, 1997, pp. 647-658; Jaumotte & Osorio Buitron, 2015).

The second trend is financialization, where the role and importance of the financial sector in economic and political affairs has increased, gaining both through growth in its traditional activities and expanding into new areas. Financial innovation produces the tools to facilitate this latter expansion. Financial innovation applied to government service delivery has generated new venture capital-type mechanisms, with Public Private Partnerships in infrastructure and now with SIBs, with private capital being invested directly in public sector activity, generating a new frontier of commodification and profit-making opportunities for capital, often implicitly or explicitly subsidized by the state. This dissertation seeks to understand the emergence of SIBs as a member of this group of financial innovations.

This dissertation sets out competing theoretical frameworks for understanding the emergence and evaluating the potential of the new and primarily unevaluated SIB delivery model as a government service delivery model targeted at improving social outcomes, generally for the most marginalized and impoverished segments of society. It is proposed that a framework which situates SIBs and its precursors historically as arising in the context of advanced capitalist development and political competition for control of the state, is the most compelling with respect to explaining the emergence of SIBs. While in our estimation the principal-agent approach is not a good candidate for explaining the emergence of SIBs, we do believe a modified cost-benefit approach can offer some guidance, for those who have been directed by decision-makers to implement SIB-type financing mechanisms.

While the dissertation is focused on a particular form of privatization – SIBs - the broader lessons and approach aim to contribute to a critical, yet constructive evaluation of neoliberal state governance. The recurrent themes of privatization and financialization as mechanisms to improve economic efficiency are often based on a simple and immutable assertion that the state is less efficient

than the private market. This ahistorical approach ignores that public enterprise arose as a part of a broader developmental state and industrial policy approach that has been associated with higher rates of growth and better socioeconomic outcomes than under liberal economic development paradigms (Chang, 2003). Furthermore, the dismantling of that approach and its replacement with neoliberal variants of governance, including privatizations that took place beginning in the 1970s, were not in response to some internal spontaneous development through competitive processes whereby private enterprises outperformed public enterprise. Rather, they were part of a regressive state-led strategy to restore private sector profitability through measures that marked the beginning of an era of growing income and wealth inequality and an expanding financial sector (Duménil & Lévy, 2004; Duménil & Lévy, 2011).

SIBs have a logical coherence from an efficiency-based perspective within a framework of neoliberal assumptions. These assumptions however are contestable, particularly in a social service context. New Public Management approaches in public administration and its Public Choice counterpart in economics have generated a constrained view of the capabilities of the public sector to meaningfully engage in economic and social development. We put forward an alternative analytical framework based on an institutionalist political economy, which recognizes the potential of public service norms reciprocity as a driving motivator of human behavior, the ability to build effectiveness in the public service, and a more balanced assessment of the value-adding potential of the financial sector. These assumptions produce prescriptions for efficient social service delivery that challenge the need for privatization. For those concerned about growing inequality, and collective responses to social and economic issues more generally, this approach provides an alternative to the perceived necessity “that what really matters is that we learn to outsource our biggest social problems to entrepreneurs, who are the only people capable of using the market to discover really big solutions” and highlights the potential that this “promotion of financial engineering is a willfully ideological project” (Mirowski, 2013, p. 355). This dissertation will compare and contrast these two

competing approaches, with the goal of informing evidence-based policy decisions in the area of prevention-focused social development investments, aimed at generating social mobility and opportunities for disadvantaged households.

## Chapter Summaries

Part A of the dissertation provides some foundational and historical information regarding the development of the SIB model. Chapter 1 highlights and classifies the defining features of the SIB model and sets up a framework to compare and contrast SIBs to other forms of publicly funded social service delivery based on their dimensions and extent of private sector involvement and responsibility. We then examine in greater detail the features of the SIB model, exploring examples of social program interventions in various policy areas and their ability to generate value for money and cost savings to governments, integral components of the rhetoric utilized by proponents to advance the model. It is shown that, independent of the procurement method, a large proportion of social interventions in areas in which SIBs are being implemented – anti-recidivism, child welfare, early childhood development, housing and homelessness prevention, active labor market programming, and public health – when using high quality experimental evidence, demonstrate high social returns on investment and often result in savings to government greater than the cost of the program intervention, laying the foundation for the expansion and viability of SIB model.

Chapter 2 provides a summary of the characteristics of the 100 SIBs launched as of December January 2018, including the number of projects, participants and funds invested, by policy area and host country. SIB contracts are traced back to funding programs and promotional initiatives spearheaded by federal and regional governments and the support of specific intermediary organizations who have advocated for and brokered these contracts. This chapter also compiles, for the first time to our knowledge, aggregate information on rates of returns faced by investors on SIB projects and the degree to which SIBs have been meeting their targets and repaying investors. This



analysis suggests that SIBs have maximum rates of return significantly higher than previously disclosed and are, for the most part, repaying investors.

The second part of the dissertation, Part B, examines efficiency-based explanations of SIB emergence. Chapter 3 outlines the case made by proponents for SIBs as a vehicle for improving the quality and efficiency of public service delivery and briefly assesses some central propositions that have been made regarding their desirable attributes over conventional procurement models, relying on empirical evidence on SIBs and their precursors. It is proposed that the case for SIBs can be reduced to three key claimed outcomes: (1) a greater number of beneficial social programs being delivered due to the incremental investment generated, (2) an increase in the quality and effectiveness of individual programs delivered due to private sector management and innovation as well as the required collaboration across government; and (3) improvements to the broader public social service system as a whole. It is found that all three of these claims are tenuous and that the most likely benefit of SIBs has little to do with the involvement of the private sector and the payment by results structure, but the centrality of strong public-sector leadership and coordination required to align incentives across the public service and the associated prioritization of preventative services. Empirical evidence regarding the efficiency-enhancing potential of contracting out and bundling of public services and privatizations more broadly brings into question the existence of net cost reductions through efficiencies arising from contracting out and privatization, undermining the explanatory power of efficiencies as the driving force explaining SIB emergence.

Chapter 4 formalizes what we determine to be the pivotal claim of SIB proponents, that SIBs lead to higher quality social service delivery, and draws upon parallels between the SIB model and Public Private Partnership model of public infrastructure delivery to articulate the efficiency-enhancing potential of SIBs utilizing mainstream economics-based contract theory. SIBs have many attributes in common with the Public Private Partnership (PPP) model of public infrastructure delivery (Gustafsson-Wright, et al., 2015; Loxley, 2013; Warner, 2013). Both models involve the bundling of

private upfront investment and financing with design and ongoing service provision in a single contract, while to varying degrees conditioning payments based on outcomes. Agency problems involved in social service delivery contracts are central in SIBs (Pauly & Swanson, 2017) and similar to those in infrastructure-based projects. SIBs and PPPs also raise similar challenges and concerns with respect to how they enter into public accounts, with auditor generals in the case of PPPs having intervened to ensure transparency. Analyzing SIBs as a PPP variant allows for the application of theoretical modelling approaches from the PPP literature, which is more established than the existing work on SIBs. It is hypothesized that this theoretical approach will help clarify the source of potential welfare gains under SIBs, pointing to positive bundling externalities and better resolution of principal-agent problems, while also having to deal with the potential for quality-shading arising in the delegated contract structure.<sup>7</sup> One implication of the model is that for SIBs to be efficiency enhancing, in most cases the SIB structure will need to stimulate changes to the project design and/or operations that would not be achieved under conventional delivery.

Part C draws upon institutionalist and heterodox theoretical perspectives, challenging the explanatory power of efficiency driven explanations of SIBs put forward in Part B. Chapter 5 presents original data compiled on the participants in SIB projects and examines the web of motivations and constraints faced by the institutional players involved in SIBs, including elected officials, civil servants, for-profit and not-for profit service delivery agencies, and investors in SIBs including for-profit investors and non-profit foundations. Chapter 5 highlights how more empirically-grounded theories of individual and organizational behavior that recognizes the importance of non-pecuniary intrinsic motivation, the centrality of reciprocity, and individuals as socially embedded can help explain the observed challenges faced by simple incentive-based schemes in the public and non-profit sectors highlighted in Chapter 3. Chapter 6, while undertaking a similar exercise for the state,

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<sup>7</sup> Quality shading refers to the ability of agents/contractors, due to their informational advantage, to reduce the quality of service delivered to their principals/customers in an incomplete contracting framework where not all aspects of the contracting relationships are verifiable and enforceable. See Hart (2003).

also seeks to demonstrate how a more careful examination of the motivations of government participants in SIBs could lead to the adoption of the model regardless of their efficiency-enhancing potential.

While Chapters 5 and 6 focus on describing the organizations participating in SIBs and their motivations, Chapter 7 turns to the broader political economic context as a driving factor in SIB emergence. Focusing on changes brought by the adoption of neoliberal governance practices, greater financialization of the economy, and the fallout of the 2008-2009 economic crisis, this chapter highlights how the congruence of these factors created an optimal environment for the emergence of the SIB model. We undertake a comparative analysis of two sets of countries, the US and the UK, who have been leaders in SIB implementation, with two countries that have minimal engagement with and government support for the model, France and Germany. It is demonstrated that the countries that have led in SIB emergence are those countries that have most aggressively embraced neoliberal governance models, and that key structural features of this institutional structure in turn facilitate the adoption of SIBs.

Chapter 8 concludes the dissertation by recapping our main findings and proposed modifications to the SIB approach, as well as introducing two broad alternatives to the SIB model that aim to more effectively achieve similar objectives, including reducing socio-economic inequality, supporting collaboration and innovation in public social programs, and promoting public investment in preventive social services. This is done without what we deem an extraneous reliance in the SIB model on private finance, and the contracting out of coordination and management responsibility, functions we argue rest more appropriately with the state. This set of alternatives is based on institutionalist and other heterodox perspectives, to provide a theoretical framework for how public coordination could result in more efficient delivery outcomes, alternative theories of the state, and the evolving contributions of nonprofit and cooperative enterprises as part of a social economy alternative. It will be also proposed that the case of state failure is not an unchangeable reality but

that an effective civil service can be developed with sufficient resources and attention. Given that significant in-kind and financial resource contributions are being made by governments to develop the program and policy infrastructure to facilitate SIBs, the question is raised regarding the opportunity cost of not investing those resources in strengthening civil service capacity to delivery and manage service delivery in partnership with the non-profit sector through conventional procurement. Finally, it will be highlighted that the framing effect of SIBs continue a longer-term and larger trend in mainstream economic analysis of social policy and economic development, focusing on technocratic and small scale 'nudge' interventions that entrenches an individualized notion of poverty and social exclusion emphasizing individual deficiencies, while marginalizing large-scale universalist approaches that may more effectively address systematic inequities. We conclude by advocating for a recognition of poverty, social exclusion and inequality as structural features of capitalism that will continue to grow in breadth and intensity if left unchecked by counter-mobilization,. Our constructed policy alternatives then contributes to an agenda for that resistance with respect to SIBs, making the case for reforming and restricting the model as well as shifting emphasis to more universalist approaches.

# Part A: The Characteristics and Emergence of the Social Impact Bond Model

# Chapter 1: THE STRUCTURE OF SOCIAL IMPACT BONDS

## Introduction

Social Impact Bonds (SIBs) are logistically complex contractual arrangements with multiple stakeholders and institutional participants, straddling the boundary between public and private social service provision. This chapter examines in detail the structure of SIBs and places them in relation to other social service contracting forms. We first introduce the SIB concept by reviewing several definitions that have been put forward by proponents and governments, then highlight and classify the defining features that are consistently referenced amongst proponent organizations and governments. After defining the various dimensions along which government and private actors can allocate activities and responsibilities, we set up a framework to compare and contrast SIBs to other forms of publicly funded social service delivery. We then examine in greater detail the features of the SIB model, exploring examples of social program interventions in various policy areas and their ability to generate value for money and cost savings to governments, integral components of the rhetoric utilized by proponents to advance the model.

It is shown that, independent of the procurement method, a large proportion of social interventions in areas in which SIBs are being implemented – anti-recidivism, child welfare, early childhood development, housing and homelessness prevention, active labor market programming, and public health – when using high quality experimental evidence, demonstrate high social returns on investment and often result in savings to government greater than the cost of the program intervention.

## I. Defining SIBs

Given the complexity of the SIB model, there exists some discrepancy with respect to what exactly an SIB is, with different definitions in some cases including or emphasizing different elements. Table 1 summarizes twelve descriptions of SIBs put forward by SIB proponents and governments who have experience with the model. The definitions are presented in full in Appendix A. Six defining elements of the SIBs were found in more than one of the definitions reviewed, with four elements consistently found in all definitions reviewed.

First, all definitions highlight that SIBs include government-issued contracts. Three of the definitions note that an SIB can be issued by non-government entities such as a foundation (Mulgan et al., 2011), a health insurance company (Office for Social Innovation and Civic Participation, 2016), or, in the international aid context, a donor agency (Gustafsson-Wright et al., 2015). In practice, the vast majority of operational SIBs in high income countries have been issued by governments or government entities.<sup>1</sup> We will take this as a defining element and classify *Development Impact Bonds* (DIBs)- SIBs in less developed countries issued by aid agencies, including foreign governments, - as a distinct instrument.<sup>2</sup> We will refer to SIBs and DIBs collectively as *Impact Bonds* (IBs). Secondly, all definitions emphasize that an SIB contract enables the delivery of a social or human service intervention or project, with the US Office for Social Innovation and Civic Participation also scoping in natural resources as an applicable field. Thirdly, all the definitions emphasize that the contract

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<sup>1</sup> Dear et al. (2016) distinguish between entities issuing the contract and the outcomes payors, and claim that “non-governmental outcome payors are not new” (p. 78), pointing to the Big Lottery Fund, an arm’s length public agency established through an Act of parliament charged with disbursing the profits of the UK’s national lottery system, and a public University in Israel, as examples, however these are both arms-length or quasi- public-sector entities. They identify private healthcare organizations and other insurance companies as potential outcome payors in future SIBs. As of January 2018, we identified five cases of non-government outcome funders, in addition to the Israeli post-secondary institutions referenced. In three of these cases government entities were also participating as outcome payer. In the remaining two cases, it was a public and a private health insurer providing the outcome payments. In the latter case the project self-identified as a “Health Impact Bond” (ABN AMRO, 2017).

<sup>2</sup> These criteria are consistent with Gustafsson-Wright and Boggild-Jones (2017) for who “a distinguishing feature of a SIB is that the outcome funder is a government entity”, and Gustafsson-Wright et al. (2015) who define a Development impact bond as a “SIB that is implemented in low- and middle-income countries where a donor agency or a foundation is the outcome funder as opposed to the government (although some combination of government with third party is also possible)” (p. 4).

payment structure is based on outcomes, as opposed to the undertaking of some specific type of programming or output.

	<u>Contract issued by gov't</u>	<u>Contract issued by gov't or some other entity</u>	<u>Funding for social or human service, intervention, or project</u>	<u>Payment to contractor based on performance, results, or outcomes</u>	<u>Financed by external or private investment</u>	<u>Contractor delivers preventative services</u>	<u>Payment of bond from savings to gov't</u>	<u>Presence of an Intermediary</u>	<u>Presence of Independent Evaluator</u>
Social Finance (Dear et al., 2016)	x		x	x	x				
Deloitte (2012)	x		x	x	x	x	x	x	
Deloitte & Mars (Cuifo & Jagelowski, 2014)	x			x	x			x*	
Young Foundation (Mulgan et al. 2011)	x*	x	x	x	x*	x	x	x	x
Liebman (2011)	x		x	x	x		x*	x	x
Gustafsson-Wright et al. (2015)	x*	x	x	x	x				
US (Office for Social Innovation and Civic Participation, 2016)	x*	x	x*	x	x*			x*	x*
Harvard Kennedy School's Government Performance Lab (2017)	x		x	x	x				X
United Kingdom (Cabinet Office, 2013)	x		x	x	x				
Australia - State of New South Wales (Office of Social Impact Investment, 2017)	x		x	x	x	x	x		
Government of Canada, (2015)	x		x	x	x				
Government of Ontario (2017)	x		x	x	x		x		

\*Indicates "may include" or conditional reference.

A fourth element that is present in all definitions is the reliance on external investment to finance the project, with investors facing some repayment and return risk contingent on the outcomes



achieved. Ten of the twelve definitions reviewed explicitly note that this is private (i.e. non-government) investment, in one it is unclear (see: Office for Social Innovation and Civic Participation, 2016), and in another “local authorities” are included as potential investors (Mulgan et al., 2011, p. 7), which would include entities owned by or creations of local or regional governments. We will term such SIBs, following Mulgan et al. (2011, p. 8), *Public Sector Social Impact Bonds*, and define *Social Impact Bonds* without the qualifier as those based on private finance, while recognizing in practice, in a minority of cases, there may be projects that include both public and private investment that is paid back with a return.<sup>3</sup>

Two interrelated characteristics that appear explicitly in a minority of definitions include: that services procured under an SIB are preventative in nature, such that they prevent negative social outcomes from occurring into the future; and that the payout of an SIB is financed by these future savings over the duration of the contract. These attributes are discussed in other sources as well, while not taken as defining features. A small number of definitions emphasize the presence of an intermediary organization and/or an independent evaluator, which we also deem common but not necessarily definitional features of the SIB model.

With respect to prevention: The Office for Social Innovation and Civic Participation (2016) notes that SIBs “often target prevention of longer-term problems”; Deloitte and MaRS (Ciuffo & Jagelewski, 2014) state that “an SIB is often targeted to be preventative rather than remedial in terms of the government objective” (p. 6); and Gustafsson-Wright et al. (2015) find that “impact bonds prioritize prevention” (p. 36) and “all but one SIB included in our study are explicitly structured around the prevention of some negative outcome such as returning to prison, remaining homeless, needing remedial education, or being unemployed. The one exception... could indirectly prevent negative

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<sup>3</sup> As of December 2018, only one SIB had been identified as solely financed by public sector investment, the Nottingham Futures workforce development SIB, where the local council carried the entire investment. Five other SIBs included public sector as well as private sector investment, including: two London-based housing/homelessness SIBs with investment from the UK Department of Health Social Enterprise Investment Fund; the Energise Innovation SIB in Thames Valley with investment from the Buckinghamshire County Council; The South Carolina healthy pregnancy project with investment from Medicaid; the Epiqus’ KOTO workforce development SIB in Finland, with investment from the European Investment Fund; and a workforce development SIB in Rural France with investment from la Caisse des Dépôts, a public sector lender (Social Finance, 2018).

outcomes” (p. 36). The UK Cabinet Office (2016) notes that SIBs “allow commissioners to attract private investors to fund early and preventative action on complex and expensive social problems”, and Liebman and Feller (2014) similarly note that the SIB model funds programs that may preclude subsequent social program expenditures. Dear et al. (2016), for example note that “Social Impact Bonds drive funding toward preventative programs and upstream interventions” (p. 16) and that “many governments are interested because [an intervention] delivers direct and immediate savings or because it will reduce future spending by intervening earlier with populations who are likely to incur high costs in the future” (p. 23). The delivery of preventative services based on the above, in addition to the three definitions that explicitly reference it, appears central to the SIB model and we will treat it as an essential characteristic.

Based on the above analysis, excluding outlier definition components, and taking some minor additional editorial discretion, we adopt the following definition: *SIBs are procurement contracts, generally issued by government, that enable the delivery of some social service intervention, bundling together design, delivery and project finance. The contract payment structure is based on the contractor’s achieved outcomes, as opposed to the undertaking of some specific programming or service output, requiring a mutually agreed upon evaluation methodology, which may involve an independent external evaluator and/or a control group to help isolate the impact of the intervention. Private investment is used to finance the project, with investors facing at least some repayment and return risk contingent on the outcomes achieved. SIBs deliver preventative social services such that the intervention prevents some negative social outcome from occurring.*<sup>4</sup>

When SIBs are based on preventative social interventions, SIBs may then preclude the requirement for some future remedial social service, generating future cost savings for a government or agency that would otherwise be required to provide the remedial service. In the case that an SIB

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<sup>4</sup> Several secondary sources including Eames, Terranova, Battaglia, Nelson, Riesenber, & Rosales (2012), Gustafsson-Wright, et al. (2015), Humphries (2014), and Loxley (2013) have outlined the basic structure of a social impact bond and, while there is some variation in nomenclature, there is a general consensus around the basic elements and stages of the SIB procurement model, they are generally consistent with our definition here.

issuer, i.e. the government, would be responsible for and required to incur these remedial social service costs, SIBs can, at least partially, be notionally paid out of the present value of these projected savings. We will call an SIB that generates expected present value savings for its issuer greater than or equal to the maximum payout under the SIB a *self-funding Social Impact Bond*.<sup>5</sup> Finally, SIBs may often include an independent coordinating entity generally termed the ‘intermediary’, to be the lead private entity, sign the contract with government, raise capital from investors, and hire and manage service providers. Figure 1 summarizes the typical SIB structure, and Figure 2 summarizes a conventional social service procurement structure for comparison.

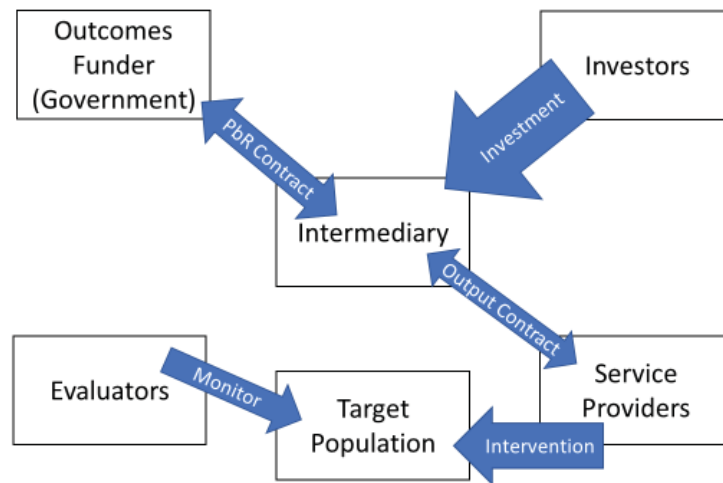


Figure 1: Typical Social Impact Bond structure

<sup>5</sup> If one of the main advantages of an SIB is its ability to self-finance, this could explain why to date in the developed world only government have been outcomes funders under SIBs. In practice, it is unlikely that any institutional entity other than a regional or national government will have the sufficient resources and the incentive to do so given the exclusive mandate and obligation to mitigate adverse social circumstances of the larger population. Since it is government that is responsible, often legislatively bound, to provide some type of assistance to its most vulnerable populations, it is only the government or quasi-government agencies such as international development agencies, that can genuinely be perceived to have an impending liability of future costs associated with neglect and the foregoing of cost-effective preventative interventions.

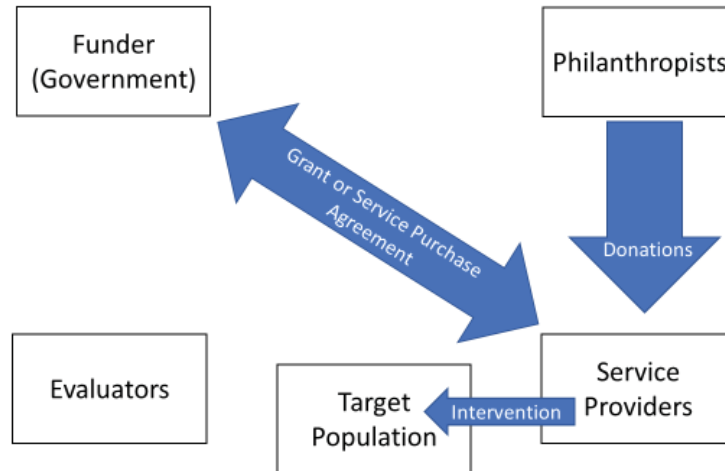


Figure 2: Conventional social service procurement structure

From a structural perspective, some key distinctions between the typical SIB and conventional procurement models that are illustrated here include: the substitution of a grant or service purchase payment structure from government with a pay by outcomes contract; the shift of private sector financial contributions from philanthropic donations to an investment expected to be paid back with a return; and the introduction of the intermediary and increased importance of the evaluator in the SIB model, who aren't necessarily present or essential in the conventional model.

Figure 3 outlines the steps in the redemption of an SIB. This payment process may occur once at the end of the contract or at predetermined points throughout the contract if payment is staggered and based on cohort or intermediate outcomes, which has become more common overtime (Dear et al., 2016, p. 27). An evaluation takes place to determine whether the targeted outcomes have been achieved. This information is reported back to government, and if the project has met its targets, payment is issued by government to the intermediary. The intermediary in turn pays out the investors based on the agreed upon terms. At this point government may desire to continue the social program intervention, and may renew or issue another SIB contract, contract directly for the services using conventional procurement or a government financed Pay by Results contract (Dear et al, 2016, pp. 80-81).

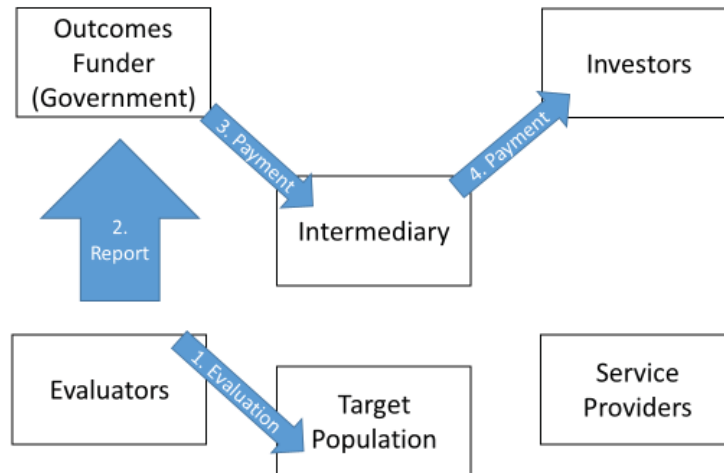


Figure 3: Social Impact Bond outcome payment process

## II. Public versus Private Dimensions in Social Service Provision

SIBs represent a unique approach to social program delivery involving partnerships that crisscross the public-private distinction along numerous dimensions. SIBs are novel and of interest in part due the way in which they challenge traditional conceptions of the activities that should be undertaken in public versus private spheres. Prior to moving deeper into a descriptive analysis of SIBs and their classification and comparison to other forms of social service delivery, we first define what we mean by ‘public’ versus ‘private’, what we mean by ‘social’ when we are discussing social programs/services and social expenditure, and will distinguish between *publicly funded*, *publicly financed*, *publicly delivered*, and *publicly controlled* when classifying social service provision.

Definitional issues with respect to the public-private distinction amongst organizations has been subject to debate and analysis from various entry points and conceptual perspectives, but generally accepted factors of central relevance when defining an organization as public or private include ownership and funding (Perry & Rainey, 1988). We apply a similar definitional approach to social programs while adding a distinction between how social programs are funded and how they finance expenditures during their lifespans.

We will adopt the Organization for Economic Cooperation and Development's (OECD) definition of public versus private, social expenditure and its categorization of social services. This not only allows us to link our analysis to an internationally recognized standard but also allows us later to make use of the OECD Social Expenditure Database (SOCX) to inform our analysis regarding the approximate universe of relevant public services that theoretically could be subject to SIB-type administration in OECD countries.

#### a) Social Expenditure, Benefits and Programs/Services

The OECD defines social expenditure as “benefits to, and financial contributions targeted at, households and individuals in order to provide support during circumstances which adversely affect their welfare, provided that the provision of the benefits and financial contributions constitutes neither a direct payment for a particular good or service nor an individual contract or transfer.... only benefits provided by institutions are included” (Adema, Fron & Ladaique, 2011, p. 90). These benefits include “cash benefits (e.g., pensions, income support during maternity leave and social assistance payments), social services (e.g., childcare, care for the elderly and disabled) and tax breaks with a social purpose (e.g., tax expenditures towards families with children, or favorable tax treatment of contributions to private health plans)” (p. 90). *Social services* therefore are considered a subset of a larger definitional concept of *social benefits*. For spending to be considered “social”, the programs need “to be intended to address one or more social purposes” and entail “inter-personal redistribution” or “compulsory participation” (p. 90). The SOCX classifies social benefits into nine categories, including “Old-age, Survivors, Incapacity-related benefits, Health, Family, Active labour market policies, Unemployment, Housing, and Other social policy areas”, with the “other” category including expenditures such as social assistance and food subsidies, and all categories being subdivided into “cash” and “in-kind” expenditures (pp. 90 & 96). The OECD tracks education expenditure in separate database, with SOCX including pre-primary education expenditures and reporting other public spending on education separately in a memorandum (pp. 89 & 123).

## b) Public versus Private funding/expenditure

Social expenditures are considered “public” when the “financial flows [are] controlled by General Government” (p. 93); otherwise the expenditure is considered “private”, with private social expenditures further classified as either “compulsory” such that they are “stipulated by legislation” or “voluntary” (p. 93- 94). Social public expenditures, according to the OECD definition, are therefore ‘public’ such that the revenue and expenditure streams used to fund the program are controlled by government and therefore can be considered *publicly funded*.

## c) Public versus Private Delivery

Within this category of publicly funded social expenditures, there are variations on delivery structure that alter the degree to which private organizations are involved in service provision. Governments may deliver the services directly by hiring staff as government employees and using government-owned assets to deliver the services directly. Under this model, services can be considered to be *publicly funded and delivered*. Examples of this direct delivery model, at least at one point in time, include public healthcare delivery in countries such as Norway, Sweden, Denmark, and Finland (Blanchette & Tolley, 2001) and parts of the Job Corps youth training program in the US (Leaman, 1989, p. 91-92).

Governments may contract-out social service delivery to regulated or unregulated private organizations, which may be non-profit or for-profit, as an alternative or parallel delivery method to direct delivery.<sup>6</sup> Conventional government procurement in this area is characterized by a direct contractual relationship with service providers, established either through partnership, negotiation or a competitive tendering process (Dehoog, 1990), with human services having a long tradition of being contracted out (Martin, 2007). In the stylized *conventional procurement model*, government

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<sup>6</sup> Leaman (1989, p. 56) notes that many examples of direct government delivery are simultaneously utilized alongside indirect delivery through contracting with third party agencies.

pays the service provider to deliver a particular program or undertake a task that is of primary interest to the government through a service purchase agreement.<sup>7</sup>

A distinction can also be made between the privatization of service delivery through contracting out and the extent to which management decisions and program design are also delegated to private sector actors. For example, under conventional procurement through service purchase agreements the scope of service activities being undertaken are generally specified by government, where in SIBs this is generally delegated to the private sector intermediary.

#### d) Public versus Private Financing

While the service provider may have some existing in-house capital assets and/or utilize shorter term bank financing to deal with in-year liquidity constraints, the conventional model is primarily based on public financing, where the government pays the services provider in regular installments as the work is completed. Publicly controlled and delivered social service models will generally be *publicly financed*, such that government funds these services upfront and directly through the standard appropriations and budget processes of government, supported if necessary by the issuance of state-backed government bonds to support required borrowing.<sup>8</sup>

Long term *private financing* of social service delivery procured by government contract is a recent development, and it will be argued below that this is one of the key distinguishing features of SIBs.<sup>9</sup> In this model, private equity or borrowing tied directly to the project being undertaken is mobilized, with in some case repayment terms being contingent on some project -related outcomes.<sup>10</sup>

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<sup>7</sup> This is distinct from a grant, where governments may fund an organization to advance its mission, but does not lead in specifying the outputs or outcomes of the activity (Pettijohn, 2013a). See footnote 1 in van Slyke (2003) for more information on service purchase models.

<sup>8</sup> See Crain and Miller (1990) for more detailed description of federal and state government budget process in the United States.

<sup>9</sup> Note that this definition of private finance is different than that used by Hodge (2000) definition which refers to “charging for previously nonpriced goods and services” (p. 15, Table 2.1), which we argue is better labeled a private funding source.

<sup>10</sup> Picot, Florio, Grove & Kranz (2016), in the public infrastructure context, refer to public financing as “pay as you go” or “cash flow” financing and the private financing as capital market financing (p. 10) and note that choice between these two models has implications on the intergenerational cost burden of the project (p. 11).



## e) Public versus Private Ownership of Assets

One additional important distinction with respect to the public versus private divide in the government service delivery context is in regard to control and ownership of the physical assets and intellectual property generated over the duration of the contract. Control and ownership may be aligned with the delivery model, whereby public delivery leads to public ownership and private delivery leads to private ownership, but this may not necessarily be the case. In the Public Private Partnership (PPP) model of infrastructure delivery case for example, the physical infrastructure asset is often owned by the private sector for the duration of the contract but is then transferred back to public sector upon contract completion. A procurement contract will ideally explicitly specify who has the rights to the assets developed and accumulated throughout the contract. Over and above how formal ownership rights are specified or determined, decisions regarding public versus private delivery will impact the distribution of knowledge and institutional capacity between the public and private spheres to effectively deliver social services that is accumulated through performance of duties, which in turn may have implications for the sustainability and accessibility of that knowledge into the future.

## f) Public versus Private Risk

A final distinction with respect to the public-private divide is with respect the allocation of risk between sectors. More recent innovations in payment structures have generated models where contractors are paid based on outcomes as opposed to the activities undertaken, increasing payment variability. In economics, contract theory frames this transfer of risk as increasing the incentive to undertake greater effort to achieve a higher quality of work, with contracts based primarily on cost reimbursement being termed *low powered*, and contracts based more heavily on outcomes being *high powered*. This shift of risk to contractors can be considered to be happening in parallel to but distinct from the “privatization of risk” discussed by authors such as Hacker (2004) where collectivist social

insurance programs are being replaced by a regime placing more burden of adverse circumstances on individuals and markets.

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Based on the above reviewed public-private distinctions, Table 2 summarizes the various public-private dimensions of SIBs and other sample social service delivery models. For each model, it is stated whether responsibility for delivery, design/management, financing, outcome risk, and funding fall to the private or public sector. Included in the table are the publicly funded and delivered and conventional procurement models defined above, as well as some variations on the SIB model including the Pay-by-Results contract, the Public Sector Social Impact Bond, and the Human Capital Performance Bond.

Table 2

*Public-Private Dimensions of Social Service Delivery Models*

Delivery Model	Private Sector Delivery of Service/ Operations?	Private Project management design and implementation?	Private Financing? (Source of Financing)	Payment based on outcomes i.e. Privatization of risk?	Reliance primarily on Private Funding? (Primary source of funding)
Public Delivery	No	No	No (Gov't operating budget)	No	No (Gov't operating budget)
Conventional input or output based contracting	Yes	No	No (Gov't operating budget)	No	No (Gov't operating budget)
Pay by Results <sup>11</sup>	Yes	No	No (Gov't operating budget)	Yes (Service Provider)	No (Gov't operating budget)
Human Capital Performance Bond <sup>12</sup>	Yes	No	No (Gov't -backed and issued bonds)	Yes (Service Provider)	No (Government operating budget or savings from prevention)
Public Sector Social Impact Bond <sup>13</sup>	Undetermined	No (Lower-level Gov't entity)	No (Gov't operating budget or other public financing)	Maybe -Service provider	No (Government operating budget or savings from prevention)
Social Impact Bond	Yes	Yes (Intermediary or service provider)	Yes (Private venture capital investment)	Yes- Investor	No (Government operating budget or savings from prevention)
Fully Privatized Social Service	Yes	Yes (Service provider)	Yes (Equity investment or loans)	Yes- Investor	Yes (Consumer or philanthropic revenues)

As can be seen, SIBs bring publicly funded social service delivery one step closer to fully privatized delivery, with the remaining distinction in this framework being that in an SIB, the government is still the end-funder of the service, where a fully privatized service would be reliant on consumer or philanthropic revenues.

<sup>11</sup> Ragin & Palandjain (2013) and Stid (2013) discuss SIBs in relation to the Pay by Results contracting structure. Some critical observers are skeptical of the benefit arising from the involvement of the financial sector in the delivery of social services, however appear sympathetic to tying payment to outcomes. Stid (2013), for example sees potential in the Pay-By-Results model, with a direct relationship between government, well-financed charitable foundations, and service providers as an alternative to the standard SIB model. This maintains results-based payments within the non-profit sector, allowing any surplus to be redeployed for further social purposes. Pauly and Swanson (2017) also note the extent to which the non-profit sector is involved in the issuance of bonds directly to finance its activities, a fact is not generally acknowledged in the SIB proponent literature.

<sup>12</sup> Human Capital Performance Bonds are a variation on the SIB model, but do not utilize an intermediary or private venture capital -type financing. Instead funds for the projects are raised through a more traditional government bond issue, with the bonds backed by the state, generating a lower cost of borrowing. The bonds are repaid through the savings linked back to the programming, as under an SIB, but it is the service providers who bear responsibility for meeting outcomes in exchange for the opportunity to reap the financial rewards of success, as opposed to external private financiers who assume risk in the SIB model. See Rothschild (2013) for additional information.

<sup>13</sup> Mulgan, Reeder, Aylott and Bo'sher (2011) put forward a concept they call "Public sector Social Impact Bonds" (p. 8), that involves the government contractee paying a lower level of government or public agency based on outcomes, who in turn finances service delivery through conventional public financing. It is then the lower level government or public agency that then acts as the intermediary.

### III. Defining Features of SIBs

SIBs are procurement contracts issued by a government, foundation, or other entity, that enable the delivery of some social service intervention. Theoretically any person, corporate or individual, with the sufficient resources and desire to see some measurable social outcome for a target population, could issue an SIB. In practice, however, restricting temporarily our scope to the developed world, outcome payors under SIBs have only to date been undertaken by government or broader public-sector entities, falling within the realm of our definition of *social public expenditures*, at least in the case where the bond is paid out,<sup>14</sup> and for the most part are *in kind* expenditures delivering *social services*.

There are several essential and distinctive features of SIBs that differentiate the model from conventional publicly controlled and financed government procurement contracts for social service delivery. These include:

- a. the bundling and contracting out of design, delivery and project finance into a single contract,
- b. an outcome-based contract payment structure,
- c. external multi-year financing of publicly funded social service operations by at-risk for-profit capital, and
- d. a focus on the delivery of preventive services.

In addition, while not universal to all SIBs, other common and notable features of many SIBs projects include:

- e. the potential to fund SIB outcome payments out of future cost savings to governments,
- f. the presence of an intermediary entity between government and service delivery agents, and
- g. the presence of an external evaluator and/or randomized control group-based evaluation methods

We discuss each of these two sets of features briefly below.

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<sup>14</sup> Social expenditure undertaken under an SIB that was unsuccessful in meeting its targets and in turn did not success in triggering payment could be considered private social expenditures, although it is unclear at this point how or if these expenditures would be captured in SOCX statistics.

## a) Bundled and contracted-out project design, delivery and finance

The bundling and contracting out of social program design, finance and operations into a single outsourced contract between government and a private sector led consortium is a defining feature of an SIB.<sup>15</sup> To the extent that a lead external (private/non-government) agent, either a service provider or an intermediary, takes on the coordinating and management role to determine the scope, type and arrangement of the intervention, SIBs then involve privatizing some design and management activity that would have been undertaken by the state in conventional social service delivery (Whitfield, 2015, p. 23). Similarly, with the introduction of private financing, the SIB models bring contracting-out a step closer to a fully privatized service delivery model.

This bundling and contracting out is similar to the contracting relationship utilized in a Public Private Partnership (PPP) model of infrastructure delivery, where bundled contracts are issued for the design, construction, maintenance and/or delivery of infrastructure-based public services (Gustafsson-Wright, et al., 2015; Loxley, 2013; Warner, 2013). PPPs also have a history of support, promotion and capacity development through arm's length government and third-party entities, generating what Whiteside (2013) has termed "enabling fields" (p. 96), similar to the SIB case.

PPPs are claimed to save governments money by imposing a life-cycle cost perspective on capital assets procurement, and better aligning incentives while transferring risk from government to the private sectors. Based on this rationale PPPs infrastructure projects continue to proliferate, but have also been controversial due to the privatization of public sector assets, high investor profits, reduction in job quality, and the lacking evidence of cost reduction or risk transfer of any substance (Loxley, 2010; Whitfield, 2017). The shared features, and applicable experience with and theoretical insights from the PPP model are explored in more detail in Chapters 6.

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<sup>15</sup> In one exceptional case, the Swedish SKL Mission Mental Health Health Navigator SIB, all service provision was undertaken by a municipal public-sector organization generally funded by the national government, with outcome payments committed by the municipalities (Backström, 2016). Like other SIBs, the project was financed by private investors. Other SIB projects have included public sector partners in the private sector led consortia; for example, public schools have been service delivery agents in several SIBs including Utah High Quality Preschool Program, the Chicago Child Parent Centre PfS project, and the Portuguese Junior Code Academy SIB (Social Finance, 2018).

## b) Payment structure based on outcomes

SIBs rely on a sharp distinction between the inputs, outputs and outcomes of a social service intervention, as outlined in Morse (2015) and Department for International Development (2014). Inputs refer to the resources that are used to implement the intervention, and can include physical assets, paid and unpaid human resources, and knowledge generated research and development activities. These inputs are combined in service delivery processes, based on existing service production technology, that produce specific service outputs, and include competing models and combinations of possible interventions. Outputs include for example the number of clients, households or communities receiving an intervention or reductions in wait times for service, and in general produce measures of specific processes undertaken and completed within a specified timeframe. These outputs are anticipated to generate improved outcomes for stakeholders participating in the interventions, such as a reduction in incidents of recidivism, formerly at-risk children living safely with their family, sustainable employment for previously unemployed or underemployed workers. In contrast to outputs, outcomes are of inherent value to the individuals and households served and often to broader society in that they improve the quality of life. They are the targeted objectives of the program in which the intervention can feasibly achieve. These outcomes may in turn lead to desirable long-term widespread societal impacts but would require significant scale to translate in improvements in aggregate statistics, such as lower crime rates, improved educational attainment, fewer households living in poverty, and reduced unemployment.<sup>16</sup> Figure 4 summarizes these distinctions.

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<sup>16</sup> Heckman, Heinrich, & Smith (2011b, p. 40) emphasize an alternative distinction between outcomes versus impacts; where outcomes measure the achievement of a benchmark, or the level of achievement, impacts attempt to measure the difference that the intervention made relative to where the client would be without the intervention. Measuring impact is difficult and can be expensive, and comes with a significant time lag. They highlight that PFS initiatives traditionally have focused on shorter term measures to allow service providers and funders to respond in a timely manner.

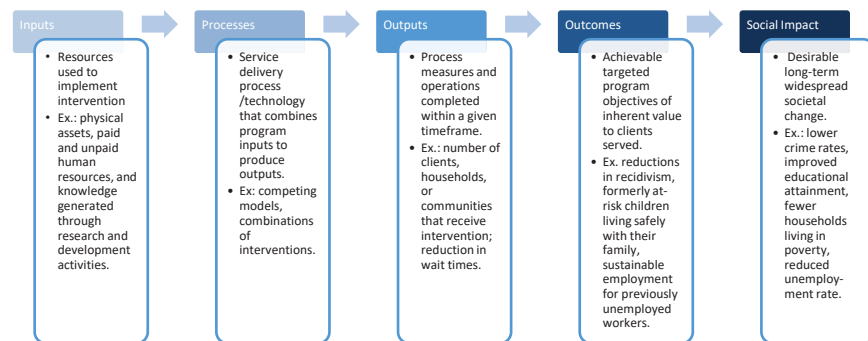


Figure 4: Inputs, outputs and outcomes. Adapted from Morse (2015) and Department for International Development (2014).

SIB contracts remunerate consortia through a pay-by-results (PbR) or pay-for-success (Pfs) structure, based on performance-based contracting (PbC), such that payment to the consortium is based on clearly articulated targeted objectives specified in terms of outcomes. In high-powered incentive versions of PbR, if the consortium does not meet the agreed upon objectives the government is under no obligation to pay, or payments are significantly reduced, while lower-powered incentive versions may implement a more tiered or graduated payment structure based on a range of achieved outcomes. Paying only for results is an extreme example of “best to best” budget structures, one of the incentive-based tools used in target and performance-based governance systems; others include reputational or “naming and shaming” approaches, outcome based management compensation, and organizational independence (Bevan & Hood, 2006, p. 519).

The Partnership for Public Procurement (2012), created by two international procurement professional associations, the Chartered Institute of Procurement & Supply (CIPS) and the Institute for Public Procurement (NIGP), defines PbC as “a results-oriented contracting method that focuses on the outputs, quality, or outcomes that may tie at least a portion of a contractor’s payment, contract extensions, or contract renewals to the achievement of specific, measurable performance standards

and requirements, [...and] may include both monetary and non-monetary incentives and disincentives” (p. 1). In government contracting, the contract-specific duties of the contractor are specified in either “design” or “performance specifications”, with PbC relying extensively if not exclusively on the latter, providing greater discretion in how the objectives are operationalized, “allowing for innovation” (Martin, 2015, p. 65).

The implementation of PbC and PbR contracts has been far from uniform, with much variation with respect to the specific metrics and incentives utilized (Palameta, Myers, & Conte, 2013). The academic and professional literature is also not consistent in its nomenclature with respect to defining PbR, in some case using the term to refer to both contracts based on outputs and outcomes, particularly in the healthcare field.<sup>17</sup> We will follow the UK Comptroller and Auditor General (Morse, 2015, p. 11) and reserve the PbR term to refer to contracts based on outcomes, which appears to be consistent with the evolution of usage of the term more recently. PbR, outcomes-based contracting, and PfS, the more common term in the United States, will be used interchangeably, and we will use PbC to refer to the larger universe of contracts based on realized quality, outputs and/or outcomes. This definitional structure is summarized in Figure 5.

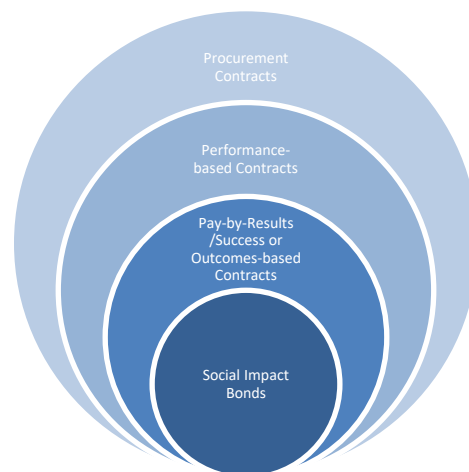


Figure 5: Distinguishing PbC, PbR/PfS and SIBs

<sup>17</sup> See for example Mason and Goddard (2009, p. 3) and discussion in Laguarde (2013, p. 7).



In the United States, since the modern emergence of large scale social service procurement in the 1960s, there has been a shift from design-based criteria, to output specification, and in the 1990s to PbC (Martin, 2007), with PbC now being identified as the standard or preferred form of contracting by US government agencies and half of federal government procurement utilizing this model (Martin, 2015). US active labor market programs have utilized incentive contracts with providers since the 1990s, with the Job Training Partnership Act allocating six percent of its funding to states for incentive bonuses to training providers, and its successor, the Workforce Investment Act instituting bonuses and penalties to States based on performance outcomes (Courty, Heinrich, Marschke & Smith, 2011, p. 24). More recent expansion of incentive based schemes has led to the utilization of “performance standards systems and bonuses” in “the Supplemental Nutrition Assistance Program... and welfare-to-work programs, [other] employment and training programs [including adult education (see Palameta, Myers, and Conte, 2013)], public school account-ability systems under No Child Left Behind, child welfare agencies and child support enforcement programs, Medicaid and SCHIP programs, and other social programs” (Heckman, Heinrich & Smith, 2011, p. 2). PbR has also been used in the defense industry (Ng, Maull & Yip, 2009).

In the US healthcare sector, PbC has proceeded under the guise of ‘Value-based Payments’ (VbPs) and ‘Accountable Care Organizations’ (ACOs), with President Obama’s last Secretary of Health and Social Services prioritizing implementation within Medicaid and Medicare programs with the objective of having “30% of Medicare payments tied to quality or value through alternative payment models by the end of 2016, and 50% of payments by the end of 2018” (Burwell, 2015, p.

897).<sup>18,19</sup> The growth of VbPs and ACOs in the US has been credited to the Patient Protection and Affordable Care Act which increased electronic patient record collection requirements growing the data base available on which to set outcomes based payments, and launched the Medicare Shared Savings Program which “establishes financial incentives for accountable care organizations (ACOs) to provide coordinated, well integrated care” (Delbanco et al, 2011, p. vi). There is also significant growth of outcomes-based finance in the United States at the State level, with PbR being used in areas such as active labour market programs, services to persons with disabilities, and adoption (van Slyke, 2006, p. 160). In 2010, “89 percent of surveyed human service non-profits had government contracts or grants that required them to report to funding agencies the results, outcomes, and impact of programs and services, and 17 percent had performance-based payments” (Pauly & Swanson, 2014, p. 8).

In the UK, PbC was initially implemented on a wide-spread basis in healthcare through the Quality and Outcomes Framework launched in 2004 where pay by results-type provisions were integrated in to compensation agreements with physicians in the National Health Service (Green & Nash, 2009). It has since been implemented intensively in healthcare (Epstein et al, 2004) including mental health (Mason & Goddard, 2009), active labor markets programming, and criminal justice (Fox & Albertson 2011; Warner, 2013), as well as in family services, welfare, and international aid projects (Morse, 2015). PbC is not a recent phenomenon the UK, going as far back as 2003 in the healthcare field (Fox & Albertson, 2011) and covering the majority of the national health services by 2005 (Audit Commission, 2005). The implementation in “welfare-to-work” schemes took place in the 2000s with

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<sup>18</sup> VBP models are “defined as financial incentives that aim to improve clinical quality and outcomes for patients, while simultaneously containing (or better yet) reducing health care costs” and “seek to change the behavior of individual providers and provider organizations by aligning payment with value” (Conrad, Vaughn, Grembowski, & Marcus-Smith, 2015, p. 2). An ACO is a “provider-led organization whose mission is to manage the full continuum of care and be accountable for the overall costs and quality of care for a defined population” (Rittenhouse, Shortell, & Fisher, 2009, p. 2302) and “emphasizes the alignment of incentives and accountability for providers across the continuum of care” (p. 2301). See Delbanco et al. (2011) for discussion of ACOs focused on shared risk models where the providers bear some payment risk based on outcomes.

<sup>19</sup> The utilization of the terms ‘Payment by Results’ and ‘value-based payments’ in the healthcare field is not always strictly restricted to payments based on outcomes and has been applied to some output based compensation schemes. See Bhattacharyya et al. (2009), Delbanco et al. (2011), and Morse (2015, p. 11).

60% of payments based on outcomes (Morse, 2015, p. 4). PbR contracts have also become increasingly common in UK management advisory services to government focused on austerity and budget cuts, with management consultants being paid based on a percentage of the savings achieved (Peretti, 2016). Recent growth in PbR contracting in the UK has been traced back to cabinet direction in the 2011 Open Public Services White Paper encouraging their use, and as of 2015 the UK government's PbR portfolio included at least 52 projects worth 15 Billion pounds (Morse, 2015). Australia and the Netherlands have also embraced PbC with outcomes based contract components, with both countries utilizing the model for active labour market programming as far back as 1998 and 2002 respectively (Finn, 2008).

It is clear, based on the review above, that having government contract on outcomes as opposed to simple fee-for-service contracts is a concept that predates the emergence of SIB financed projects. Countries that were early adopters of PbR have been the early adopters of SIBs. Over the last 30 years, in countries that have led in SIB implementation, we have seen the emergence of PbC with movement from contracts with design specifications to contracts based on outputs, followed by an increasing emphasis on contracting based on outcomes, with monetary payments linked to the degree of achievement with respect to contracted objectives. SIBs therefore are only one of the latest iterations of government procurement contracting structures with a stated goal of improving the value government receives for its expenditures flowing to third-party agencies, captured under the broader PbR model (Rothschild, 2013, p. 104; Stid, 2013, p. 13).

### c) Project Services Financed by External, For-profit, at-risk Capital

This third defining feature of SIBs, the use of multi-year venture capital type financing to cover project operating expenses for the duration of the project, distinguishes SIBs from other outcomes-based contracting models, where the service provider itself takes on the risk of non-payment. The inclusion of 'bond' in the name 'social impact bond' is somewhat misleading as there are generally no ongoing regular payments from government to investors during the contract span. SIBs are in fact

closer to a venture capital investment or equity investment than a traditional bond, with the payment of principal and return semi-periodically throughout the contract or as a lump sum at the end of the contract, but only if the agreed-upon objective thresholds are met (Loxley, 2013; McHugh et al., 2013; Rothschild, 2013, p. 107).

SIBs have attracted investment directly or through pooled funds primarily from mainstream financial corporations such as Goldman Sachs, JP Morgan, Deuchebank, as well as wealthy individuals, and philanthropic charitable foundations. Pensions funds and government entities, to a lesser degree, have also invested in social impact bonds (Gustafsson-Wright et al., 2015, pp. 58-129).<sup>20</sup> For private investors, SIBs provide an opportunity to receive a financial return while also generating a non-monetary benefit in the form of perceived corporate-social responsibility. For charitable foundations, SIBs may allow endowments to be invested in a manner which more closely aligns with their charitable missions, relative to traditional investment opportunities. Foundation participation may also project an association of a foundation with new trends in philanthropy associated with the broader concepts of social entrepreneurship and social finance, facilitating organizational objectives to advance the goals of the organization and maintain relevance and attractiveness to donors.<sup>21</sup> The composition and motivations of SIB stakeholders are examined in greater detail in Chapters 5 and 6.

Philanthropic foundations, wealthy individuals and corporations providing financial support to social service interventions is not a new development and is clearly not limited to SIBs, with earlier private social service delivery models based on service providers assembling private sector financial support based on a combination of donations and philanthropic investments with repayment obligations, sometimes termed “Program Related Investment” (PRI; Gustafsson-Wright et al., 2015,

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<sup>20</sup> We were able to identify one SIB project to date has been fully funded by public sector investors, the Nottingham Futures SIB, funded by Nottingham City Council. Six other projects were identified that were partially financed by public sources, including: the London Street Impact, Thames Reach, Energise Innovation in Thames Valley, South Carolina Nurse Family Partnership, Epique's KOTO, and the rural French workforce development SIB projects.

<sup>21</sup> The concepts of Social Finance and Social Entrepreneurship are discussed further in Appendix F.

p. 37). One main difference with SIBs is the venture capital type investment with the conditional repayment structure, instead of donations or grants, which are non-repayable, or loans, which have the obligation of repayment regardless of outcomes (Pauly & Swanson, 2017). With respect to PRI, this has resulted in investment in “human capital” through social services instead of the more traditional PRI physical assets such as housing and economic development projects (Gustafsson-Wright et al., 2015, p. 37). The venture capital model in SIBs generally shifts the PbR mechanism from the service provider level to the investor class, a key departure from previous outcome based PbC contract structures. This has been claimed to allow SIBs to achieve a greater scale, remove the operational risk from individual service providers, and enable participation from service providers who could not individually finance upfront costs under conventional payment-by-results schemes (Stid, 2013; Office for Social Innovation and Civic Participation, 2016).<sup>22</sup> In practice however, some service provider in addition to investors are being compensated partially based on results.<sup>23</sup>

The participation of at-risk, for profit-private finance in the delivery of public services with the expectation of a financial return is not a new concept, with direct private investment in public infrastructure having a long track record going back at least to the development of the first railway systems and electrical utilities (Cassis, 2016), if not as far back as the Hellenistic period of ancient Greece in 318 B.C. (Goldsmith, 2014, p. 11).<sup>24</sup> Modern railway and electrical systems however were not fully publicly funded enterprises, and it appears that it was not until the development of the Public Private Partnership (PPP) model of infrastructure delivery, discussed in more detail in

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<sup>22</sup> Many service delivery agents in the social services sector are incorporated as non-share capital or non-profit organizations, which may impose limitations on their ability to borrow based on perceived risk and limited ability to provide collateral security. However, as Pauly and Swanson (2017) note, non-profits still do engage in borrowing and do in some cases issue bonds directly.

<sup>23</sup> Pauly and Swanson (2017) identified 14 SIBs launched prior to January 2018 where 18 service providers or intermediaries are investors and/or are being compensated partially based on results. We identified an additional 11 including: the Buzinessclub Rotterdam SIB, the Caritas Fokus Bern Swiss refugee employment SIB; the Age UK Worcestershire Health Reconnections SIB; the Santa Clara Project Welcome Home PFS project; the South Carolina Nurse Family Partnership PFS project; the ASCO ON TRACC New South Wales anti-recidivism SIB; the Enschede Werken in Duitsland SIB; the APM Workcare Auckland SIB, the Greater Manchester Homes Partnership SIB, the Ventura County Project to Support Reentry PFS project, and the Kent County Strong Beginnings Pay for Success (Social Finance, 2018; Third Sector Capital Partners, 2014; Tomkinson, 2014).

<sup>24</sup> See Wettenhall's (2005) review of the long history of the private provision of public funded goods spanning a variety of sectors

including military, trade, treasury services, agriculture, health, education and infrastructure.

Chapter 4, that the modern multi-year private financing for publicly funded and procured service delivery emerged. The promotion of private financing of public infrastructure is also being advanced more broadly through calls for a national infrastructure bank in Canada (Sanger, 2017) and President Trump's commitment to support private infrastructure investment through generous tax credits (Ross & Navarro, 2016, p. 4).

Within the realm of social programs specifically, for-profit at-risk private finance of social services has extended precedent, in the international aid context in particular. The Microcredit and Microfinance movements, based on the pioneering work of Muhammad Yunis and the Grameen Bank, which aim to reducing poverty through the facilitation of small scale entrepreneurship and business development, are a well-known example in operation for over three decades (Rahman, 1999). Through the more recent but broader movements of social finance and social investment, the mobilization of for-profit risk capital for social good has expanded in both advanced economies and developing countries, however these efforts until recently have operated in parallel to, not through state procurement and delivery of social services.<sup>25</sup>

Therefore, while private multi-year, for-profit, at-risk capital has previously been mobilized and invested in non-government social-purposed initiatives as well as public sector infrastructure assets, and privately-sourced donations have long supported public social service delivery, SIBs are a convergence point of these distinct and evolving trends. SIBs appear to represent the first replicable and distinguishable widespread model for private, multi-year financing of publicly-funded social service operations, as opposed to just physical infrastructure, by at-risk, for-profit capital.

#### d) Delivery of preventative social services

A key characteristic of services procured under an SIB is that they are preventative in nature (Mulgan et al., 2011; see also Table 1), such that their undertaking would prevent some undesirable social outcome from continuing or occurring. Sectors that have been commonly targeted in SIB

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<sup>25</sup> See Appendix F for further discussion of the social finance and social investment.

projects include anti-recidivism programming, child welfare (family preservation and maltreatment prevention), early childhood development, active labor market interventions, housing and homelessness prevention, and disease prevention - see Chapter 2 for further discussion. There is a large body of literature examining the effectiveness of prevention-focused social program interventions. For illustrative purposes and as a brief introduction to the types of interventions undertaken in SIBs, we provide examples of research into the ability of social interventions to alter outcomes based on the areas of social interventions with the largest number of SIBs to date, by reviewing select meta-analytical studies in each area. As of January 2018, the six most common social policy areas for SIB utilization included criminal justice, early years and education, child and family, housing and homelessness, workforce development, and health (Social Finance, 2018).

#### Anti-Recidivism Programing

In the field of anti-recidivism programming, Lipsey and Cullen (2007) review an array of meta-analytical studies that are based on “hundreds” of articles on the subject, with few obtaining the ideal of large sample size, random assignment, high program treatment integrity, and low attrition, with many based on “quasi-experiments with nonrandomized control groups, modest sample sizes, and varying completion and attrition rates” (p. 299). They conclude that correctional interventions such as supervision, increased monitoring, more severe penalties, and “tough love” approaches are not “especially effective in reducing the recidivism of the offenders to whom they are applied” and in some cases were associated with increases in recidivism (p. 300), while rehabilitation services offer more promising outcomes.

They find that supervision-based programs demonstrate recidivism reductions of 2% to 8%, while greater sanctioning and punitive reform approaches lead to a range of predicted outcomes between an 8% reduction up to a 26% increase in re-offence. Interventions that are focused on rehabilitation, demonstrate consistently positive impacts, meta-analysis average effects ranging from 10% to 40% reductions, with most estimates centered near 20%. Programs that were found to

be the most successful focus on identifying and changing behavior that is associated with criminal acts but can be altered through an intervention, and maintaining program standards and implementation integrity.

One important caveat noted is that many of the published studies included in the meta-analyses were based on research projects designed and implemented by the researchers themselves, and that these projects have been shown to have outcomes that are up to twice as effective as non-researcher designed interventions, which would constitute the majority of those implemented in practice (p. 315). In general, they note the large gap between the programming that has shown to be effective in peer reviewed research and program implementation in practice more broadly. This suggests that program integrity is not consistent or that projects with researchers involved benefit in some other manner.

MacKenzie and Farrington (2015) conduct a more recent review of randomized control trials and meta-analyses conducted since 2005. Their review is broadly consistent with the findings of Lipsey & Cullen (2007), noting that “prison sentences, correctional boot camps, intensive community supervision and other interventions designed to increase control or make punishment more onerous are not effective in reducing recidivism... [and] there is little evidence that providing delinquents and offenders with opportunities in the community like jobs and housing is successful in reducing recidivism if these opportunities are not combined with some type of rehabilitation that focuses on thinking, problem solving, or cognitions” (p. 589). They find that interventions such as “cognitive skills training, drug treatment ... and education” are effective at reducing recidivism (p. 589).

#### Child Welfare

In the field of child welfare services, programs aimed at keeping at-risk children living safely at home with their families have shown promising results, motivated by the negative outcomes facing



children taken into care.<sup>26</sup> Intensive family preservation services (IFPS),<sup>27</sup> and in particular those following established models such as the Homebuilder program, have demonstrated success at keeping children with their families and reducing foster care placements (Schweitzer, Pecora, Nelson, Walters, & Blythe, 2015, p. 424-425). Schweitzer et al.'s 2015 meta-analysis, limited to a small number of studies (four) utilizing control group counterfactuals, found the majority (three) of studies demonstrating significant treatment results, with placement in foster care rates being reduced in the range of 27% to 90%, while the remaining study only saw statistically significant reductions in placement effects for those under court petition, however this study suffered from deviations from prescribed program standards which may have compromised treatment integrity. The evidence base on IFPS is not however unambiguous, with other meta-analyses with less restrictive scope and inclusion criteria such as Al et al. (2012) and Fraser, Nelson and Rivard (1997) showing no impact on placement rates.

Multisystemic Therapy (MST), a therapy program for youth that has been used in both anti-recidivism and child welfare settings, has shown effectiveness in reducing recidivism rates as well as reducing foster care or other out-of-home retreatment placement, with treatment effect, measured by the standardized mean difference, of 0.201 and 0.267 respectively (van der Stouwe, Asscher, Jan, Stams, Deković, & van der Laan, 2014).<sup>28</sup>

### Early Childhood Development

There is clear interdisciplinary evidence that the experience of individuals in their early childhood years lay the foundation for future success and are formative in their impact on life

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<sup>26</sup> Children entering foster care have significantly worse educational and health outcomes, are more likely to rely on social assistance, have addiction issues and be involved in the criminal justice system later in life; and when compared to other children in marginal situations that may lead to removal from their family and foster care placement, fair even worse with respect to delinquency, teen pregnancy, and earnings outcomes relative to those who stay with their families (Doyle, 2007). See also Social Finance (2014).

<sup>27</sup> Intensive family preservation services are based on a combination of "case management and intensive therapy and other services;...small caseloads of two to six families; a team approach; 24-hour/7-days-per-week availability; a wide variety of helping options (from "concrete" to clinical services); in-home services with maximum use of natural helping resources; individualized, empowering interventions; and intensive (6 to 15 hours per week) and time-limited (1 to 4 months) services" (Schweitzer, et al., 2015, p. 424-425).

<sup>28</sup> This is calculated as the difference in mean between the control and treatment groups divided by the within-group or pooled standard deviation.

outcomes, with negatives outcomes being traced back to a “lack of cognitive and non-cognitive stimulation given to young children” more “than simply from the lack of financial resources” (Heckman, 2006, p. 1900). In the areas of Early Childhood Development (ECD) interventions, Blau and Currie (2003) review four rigorously designed randomized control trials with low attrition rates and high treatment integrity, that analyze the impact of early childhood development interventions for disadvantaged children in the United States with respect to their future school performance and other outcomes, specifically in the areas of “cognitive skills, school readiness, and social and emotional development” (p. 40-41). They found support for the effectiveness of interventions, with the most intensive interventions seeing the most marked results.

One of these studies, the Perry Preschool Project, involved a two-year intervention with half-day daily preschool, weekly 1.5 hour at home sessions for most of the year, with highly educated teachers and small student teacher ratios, and saw “positive effects on achievement test scores, grades, high school graduation rates, and earnings, as well as negative effects on crime rates and welfare use” (p. 44). It was later shown by Heckman, Pinto a Savelyev (2013) that the success was based mostly on improved social skills as opposed to academic competency.

Another program, the Carolina Abecedarian Project, delivered through an augmented fulltime childcare setting starting at birth and continuing until the children entered school, saw children who received the intervention obtain “at age 15...higher scores on achievement tests (especially reading) and reductions in the incidence of grade retention and special education” and “at age 21... higher average tests scores and were twice as likely to still be in school or to have ever attended a four-year college” (Blau & Currie, 2003, p. 43). A third fulltime childcare based study, the Milwaukee Project, with a relatively small sample size, saw statistically significant increase in IQ, and a second small sample study, the Early Training Project, with a less intensive intervention saw “dramatic” reductions in special education placement once in school, with an 83 percent reduction in the need for special education services relative to the control group (p. 42).

Blau and Currie also note that the level of support provided through the experimental studies reviewed above are significantly higher than those provided in practice through broad-based public programs, specifically the Head Start program in the United States, which has not been subjected to any randomized control studies. Still, early results from a newer Early Head Start program aimed at better meeting the needs of infants and toddlers included a randomized control group component, with early results showing that those children participating saw “significantly higher scores on several tests of cognitive development, exhibit less aggressive behavior, and less negative behavior towards parents during play, and are also better able to devote sustained attention to an object during play” (p. 55).

It is important to note that quality programming plays an integral role with respect to the ability of childcare interventions to deliver positive outcomes (Heckman, 2013, p. 2059, fn. 22). Some studies of the \$5-a-day universal childcare program in the Canadian province of Quebec, for example, suggest that how the program had a negative impact on child outcomes with respect to behavior and cognitive ability (Baker, Grouper, & Milligan, 2008; Haeck, Lefebvre & Merrigan, 2015) Low quality due to rapid implementation was suggested as the cause, with the program relying heavily on home-based care, lack of observance of student teacher ratios, and incentives that encouraged parents to leave very young children in childcare for long time periods (Haeck et al., 2015).

#### Housing and Homelessness Prevention

The notion of the use of housing interventions for broader social benefit is an idea that has deep roots in urban social policy, with more recent research connecting low quality and precarious housing and homelessness to lower educational outcomes for children and poor health outcomes (Mueller & Tighe, 2007). The idea of placing homeless populations directly into stable affordable personal living accommodation, as opposed to addressing homelessness through temporary shelter or transitional housing has gained momentum under the “housing first” model, which in addition to providing stable permanent housing is defined by the associated social supports either on- or off-site

and no expectation of having challenges such of addictions or mental health already addressed (Aubry, Nelson, & Tsemberis, 2015, p. 468; Ly & Latimer, 2015, p. 476). Housing First is linked back the Pathways to Housing model introduced in New York City in the early 1990s, and is based on the tenets of: “immediate provision of housing and consumer-driven services; Separation of housing and clinical services; Providing supports and treatment with a recovery orientation; [and the] Facilitation of community integration” (Aubry, Nelson, & Tsemberis, 2015, p. 469). In contrast, more traditional approaches emphasize “treatment first” with graduated programming suites and housing being targeted at later stages of intervention, with inferior results (Aubry, Tsemberis, Adair, et al., 2015 p. 463). Early studies of the effectiveness of housing first approaches found that participants “obtained housing earlier and remained stably housed longer, showed greater reductions in use of health and social services, and reported higher levels of quality of life” although the evidence base was limited (Aubry, Tsemberis, Adair, et al., 2015 p. 463). More recent research based on a multi-site randomized control trial in five Canadian cities confirmed previous results with 73% of the treatment group obtaining stable housing compared to 31% for the control group, and “quality of life” and “community functioning” indices were also higher for the Housing First participants, with treatment effects of 0.31 and 0.25 respectively (Aubry, Tsemberis, Adair, et al., 2015 p. 465-466). The effectiveness of *permanent supportive housing*, a program model explicitly targeted at those with addictions and mental health challenges, and similar but slightly broader than housing first, has also shown effectiveness with respect to “reduced homelessness, increased housing tenure, and decreased emergency room visits and hospitalization” (Rog et al., 2014, p. 287).

#### Active Labour Market Programs

Card, Kluve and Weber (2010) conduct a meta-analysis of 97 studies and 199 “programme estimates” based on unique program- participant group pairings and individual level data, examining the effectiveness of active labor market programs over various targeted outcomes and time horizons (p. F453). As opposed to the standard “effect size” estimate – referred to as treatment effect in the

previously referenced meta-analyses, which is most common in meta-analytic studies, they opted for a reporting of the number of statically positively significant, insignificant, and negatively significant variables under three-time horizon categories of one, two, and three or greater years. However, effect size was estimated for a subsample, providing an equally informative analysis of program impact (pp. F456-F457). Only around 10% of the studies were based on randomized control trials, with the two largest groups of studies utilizing averages of like-type generated from administrative data as the comparison group. Card et al. however demonstrate that results are robust across these variations, using 'success in finding employment after the intervention' and 'not being registered in unemployment benefit programs' as the outcome variables.

Card et al.'s meta-analysis results show that a plurality of studies consistently show a positive effect of active labor market program interventions, with the results becoming more convincing as the time frame of analysis increases. Specifically, short term impacts are significant and positive in 39.1% of cases when measured approximately one year after the intervention, growing to 45.4% for evaluations approximately two years later, and 52.9% in studies with data around the three-year mark or later. These percentages are based on different program samples based on data availability, but the growing effectiveness is also found within specific programs overtime. For programs measuring effectiveness in the short run, job search programs had positive results more often than training programs. For the subset of programs that used probability of employment, studies that found a statistically significant positive effect had a median effect size of 0.21 in the short run and 0.29 in the long run. With respect to outcomes variation amongst program types, job search assistance was more effective in the short run while classroom or work experience training was more effective in the medium and/or long run, with and subsidized public sector employment standing out as least effective.

Health

In the field of healthcare, there is wide and longstanding recognition that a healthy lifestyle focused on diet and physical activity plays an important role in preventing illness and conditions such as cardiovascular disease (Estruch et al., 2013; Sofi, Capalbo, Cesari, Abbate, & Gensini, 2008), and Type 2 diabetes (Psaltopoulou, Ilias & Alevizak, 2010) with supporting evidence that programs focused specifically on prevention can lead to behavioral changes associated with reduced risk. For example, Dunkley et al. (2014) conduct a meta-analysis 24 studies examining of type 2 diabetes prevention programs and find a mean weight reduction of 2.6 kilograms 12 months after program completion. There is also evidence that infection rates for other diseases, such sexually transmitted infections, can be significantly reduced through counselling interventions (Althoff, et al., 2014; O'Connor et al., 2014).

More recently, there has been growing acknowledgment of the importance of what have been termed the *Social Determinants of Health*, the idea that “living and working conditions shaped by public policy are the primary factors that determine how long you live and whether you live well or ill while you are alive” (Raphael, 2015, p. 8)”, with increasing life expectancy in advanced countries being driven by “improving material conditions of early childhood, education, food availability, health and social services, housing , employment security, working conditions, and other [social determinants of health]” (p. 12).<sup>29</sup> While we return in final chapter to this important debate regarding the effectiveness of individual versus social interventions, for now we simply highlight that the evidence supports that health is responsive to interventions and these interventions can prevent some negative outcomes with respect to health and wellness.

### Summary

Based on the above sample of meta-analytical studies, research supports that government intervention in the form of prevention-focused programming has a track record of positively impacting social outcomes for the targeted population in social policy areas targeted by SIB programs to date.

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<sup>29</sup> See Chernomas and Hudson (2016, pp. 95-101) for a summary and links to further literature on the social determinants of health.

## e) Financed by Future Savings to Government

Through preventing or discontinuing an undesirable social outcome, a successful social program intervention may preclude the necessity of some future government expenditures arising from formal legal obligations or informal expectations based on precedent. For example, successful reintegration services for those exiting prison can reduce future expenditure obligations on law enforcement, the judiciary and prison systems (Fox & Albertson, 2011; Lipsey & Cullen, 2007; Warren, 2007). In the field of child welfare services, investments in income supports, family violence prevention, early social worker intervention, and family reunification, can reduce future expenditure requirements associated with child maltreatment and/or placing and maintaining children in the custody of the state. Interventions in improved early childhood development opportunities can lead to reduced expenditure requirements on special education services (Blau & Currie, 2003, p. 42), and long-term reductions in social welfare and criminal justice expenditures (Heckman, 2006).

Under what we have termed as a *self-funding SIB*, governments calculate the costs of a social problem manifested in an identified population and offer to pay up to that amount to a private sector consortium that can prevent the realization of those costs through an intervention. Under this model, SIBs are restricted to projects that generate cost savings to government, in present value terms, over and above the initial private sector investment and the return on the SIB. As seen in Table 1, some proponent definitions of SIBs explicitly emphasize this ability of government to directly pay for the SIB based on the cost savings achieved, this tending to be the case for earlier definitions of SIBs. Some proponents in recent years have attempted to deemphasize the centrality of savings generation to the model (Carter et al, 2018) - for example see Dear et al. (p. 22), compared to a 2011 Social Finance publication by Barclay and Mak (pp. 7-9). Amongst governments however, cost savings continue to be emphasized.

Determining the projected net savings of an SIB intervention requires three pieces of information that may be of varying difficulty in securing and validating. In addition to (i) the degree to which an

intervention is expected to change the probability of occurrence of the negative social outcomes, as reviewed in the previous section, one requires (ii) the estimated cost of treating the negative social outcomes in the future if not dealt with preventatively; and (iii) an expected cost analysis of the expenses associated with issuing and paying out the SIB, as summarized in Figure 6. We set aside further discussion of how SIBs compare to other procurement methods with respect to how SIBs cost can be expected to compare to other procurement models until subsequent chapters, but discuss the more basic issue of cost savings from prevention below.

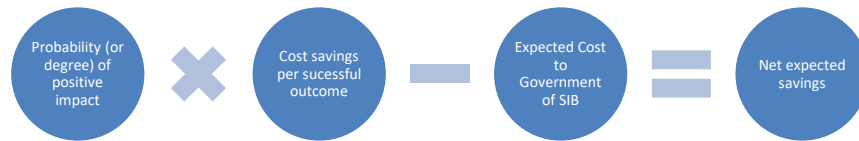


Figure 6: Per participant net expected savings of an SIB-funded intervention

There are various degrees to which an analysis informing whether to proceed with a program intervention incorporates the potential savings of that intervention. How far one ‘casts the net’ is somewhat arbitrary. One approach to classifying the savings is based on the degree to which or how directly government is impacted. For example, The New Economy Unit Cost Database (2015), endorsed and jointly “quality assured” with the UK Government (UK Cabinet Office, 2017) compiles estimated cost savings of social interventions in areas including criminal justice, employment, housing and child welfare, with cost saving estimates classified as *fiscal*, *economic* or *social* benefits. *Fiscal* benefits are restricted to direct resource savings to government that can be quantified and identified in a government budget line; *economic* costs including forgone economic benefits, specifically “earnings and economic growth” and the associated tax revenue which is lost. *Social* benefits include “wider gains to society such as improvements to health; educational attainment; access to transport or public services; safety; or reduced crime”.



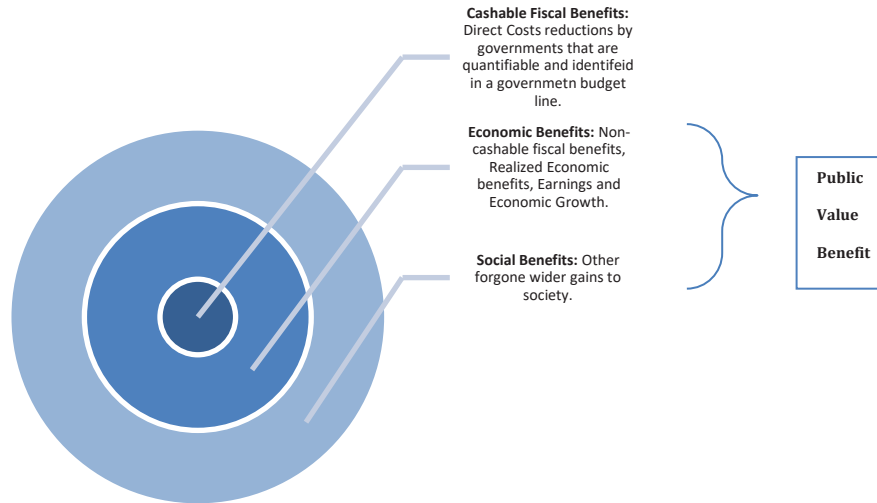


Figure 7: Cashable fiscal vs. economic vs. social benefits

A second resource endorsed by the UK Cabinet Office Centre for Social Impact Bonds that speaks to cost/benefit categorization is the *Cost Benefit Analysis Guidance for Local Partnerships* publication (HM Treasury, Public Service Transformation Network & New Economy, 2014). This resource notes that economic and social benefits may also collectively be referred to as “public value benefits” (p. 16) and that fiscal benefits can take the form of cashable and non-cashable with respect to the degree of liquidity of the savings. Cashable benefits include fiscal savings that can readily be realized as an expenditure reduction in a budget line, where non-cashable benefit frees up a non-cash resource that can be reallocated to other purposes (HM Treasury, Public Service Transformation Network & New Economy, 2014, p. 17). In general, the quantification of benefits will require making a number of assumptions regarding what cost reduction benefits to include and which can genuinely be attributed to the intervention and realistically realized. For example, whether one uses marginal versus average costs reductions, whether one counts capital in addition to operating expenditures, and the selected discount rate will all impact the outcome of the analysis (Welsh, Farrington & Gowar, 2015). The quantification of benefits for specific outcomes may be published in “rate cards” indicating a government’s willingness to pay per outcome, with providers competing under this threshold (Ramsden et al., 2016, p. 6).

As one moves from fiscal benefits to social benefits, the greater the set of variables available for inclusion and so increases the discrepancy and variation with respect to methodologies. For example, an inclusive cost-benefit framework for a crime prevention intervention presented by Welsh et al. (2015, p. 465) includes six categories of program benefits, including the direct costs avoided through reductions in crime, the benefits arising from reduced substance abuse, as well as improvements in education, employment, health, and family factors. Each category then has multiple specific benefits that may or not be quantifiable. For example, the savings from crime reduction include reduced policing, judicial and incarceration costs, avoided impact on victims, including “medical care, damaged and lost property, lost wages, lost quality of life, pain, suffering... funeral expenses, lost wages, lost quality of life (Welsh et al., 2015, p. 465). If a government is rationalizing SIB delivery based on the SIB payout being less than the projected cost savings, the selected notion of ‘costs prevented’ or benefits realized will play a significant role in determining which projects proceed and which do not. A self-funding SIB would be required to generate cashable fiscal savings sufficient to offset the SIB success payout. However, a government seeking to rationalize the SIB model in reference to an alternative, less restrictive notion of cost savings based on economic or social benefits could undertake a cost benefit analysis based on projected economic or social cost savings. A broader definition of costs including social and economic costs will allow more projects to proceed as opposed to using a strict fiscal cost rule, but only under the fiscal costs rule can an SIB be deemed revenue/expenditure neutral.<sup>30</sup>

To what degree can social program interventions deliver benefits greater than their costs? Welsh et al. (2015) conduct a meta-analysis of cost-benefit studies from a crime prevention perspective reviewing programs in policy areas where SIBs have been implemented, including early childhood development and youth employment interventions. They restrict their scope to those with

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<sup>30</sup> It should be noted that an intervention may shift cost from one category from another: for example, a reduction in fiscal costs may be offset by an increase economic or social costs. It is also of interest, but perhaps limited practical significance, that any estimate of fiscal costs will be based on the given state of social service entitlements. A relatively more generous social safety net will lead to higher estimate of fiscal cost savings of a given intervention and vice versa.

randomized control groups or "high-quality quasi-experimental designs" (p. 448). Their review demonstrates that for preventative social program interventions in program areas that SIBs have been utilized, there are significant variation in the types of benefits measured, leading to cost-benefit ratios that span from partial cashable fiscal benefit measures to more comprehensive public value measures. Of these 14 studies reviewed by Welsh et al., based on the 'benefit measured' descriptions, eight use measures of benefits limited to fiscal savings, and eight use measure that include broader public value benefits. Only three of the 14 studies reported a cost-benefit ratio less than one, with two of these based on fiscal savings, leading to two-thirds of fiscal benefit to cost ratios being greater than one. This indicates that a majority of these interventions have the potential to be viably delivered under a self-funded SIB. On average those studies based on fiscal savings produced an average ratio of 2.13, relative to 3.17 for all studies listed.<sup>31</sup>

The advantage of meta-analysis studies such as Welsh et al. (2015) is that they are based on realized, context-specific evaluations of cost-benefit program impacts in precise institutional settings. Other meta-analyses of cost-benefit studies have been done in program areas where SIBs have taken place, including health care and disease prevention (ex. Nuckols et al., 2017; Sun, You, Almeida, Estabrooks, & Davy, 2017) housing and homelessness (ex. Ly & Latimer, 2015), and workforce development (ex. Jespersen et al., 2008). A significant limitation with this meta-analytical approach however is that it is difficult to meaningfully compare and translate the impact of an interventions from one jurisdiction to another.

First, as can be seen in the studies reviewed by Welsh et al. (2015), programs in the same policy area can be quite varied with respect to what services are being delivered. Ly and Latimer (2015), for example describe an "almost bewildering variety of program configurations" in the housing first studies (p. 447). Secondly, as already noted in Welsh et al., studies do not consistently utilize the same

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<sup>31</sup> Averages are based on full sample results. When a cost-benefit range is reported, the low end of the range was utilized to calculate the average.

set of inclusion criteria with respect to monetizing the benefit generated by the intervention, with significant variation between studies in what is and is not counted. Thirdly, ratios of cashable fiscal benefits to costs of a specific social program intervention will vary from jurisdiction to jurisdiction due to local input costs and entitlement differences.<sup>32</sup>

An alternative approach is to take a single jurisdiction, and based on average treatment effects experienced across jurisdictions, conduct a cost benefit simulation exercise. The Washington State Institute for Public Policy (WSIPP), a non-partisan entity of the Washington State Legislature, has constructed and applied a cost benefit model that can form the basis of such an approach. The WSIPP benefit cost model is a peer-reviewed model and research produced from the model has been published in academic journals (WSIPP, 2017, p. 9). The institute is well-regarded and respected by both academics and policy makers and is recognized as a leader cost benefit policy evaluation, particularly in the analysis of criminal justice and prevention policy evaluation (Farrington & Welsh, 2014). It also has been referenced as a potential data source to inform SIB initiatives (Liebman & Sellman, 2013, p. 17).

WSIPP's uniform approach generates benefit-cost ratios that are robust and comparable between program areas, based on meta-analytical averages generated from high-quality analyses of treatment effects, including the inclusion of "linked or indirectly measured" outcomes that may not be considered in the original set of evaluations, corrected for double counting of effects (WSIPP, 2017, p. 8).<sup>33</sup> The model accounts for program impacts on a number of health and education variables which are commonly utilized in micro-level cost benefit analysis, including: high school graduation, standardized student test scores, number of years of completed education, higher education

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<sup>32</sup> Cost benefit analyses, based on broader public value benefits would likely have less variation due to cost savings being counted regardless of whether they accrue to the government or society more broadly, assuming uniform programming and treatment integrity, but as discussed above in Section 5d, in practice interventions in specific policy areas are far from uniform.

<sup>33</sup> For example, improved educational performance may impact multiple indicators, such as standardized test score, high school graduation rates, that may lead to higher earnings. The WSIPP model will only count the effect once. For more on the double counting procedure see WSIPP (2017, p. 173-174).

achievement, as well as morbidity and mortality costs of alcohol and illicit drug disorders, regular smoking, mental health disorders, health care outcomes, and child abuse and neglect (WSIPP, 2017, p. 35). The cost and benefit implications are calculated assuming program implementation in Washington State, in net present value terms, but the impact of the intervention is drawn broadly from published data using a meta-analytic approach. The estimated benefit and cost impacts of the program intervention are classified into four categories based on the ability to assign benefits and costs to one of the following groups: (1) program participants, (2) other individuals, (3) “taxpayers” representing cost and benefits accruing to the state, and (4) those that are more indirect and not clearly attributed to the state or specific individuals, such as the deadweight loss of taxation (WSIPP, 2017, p. 9). The reporting of benefits and costs accruing solely to the ‘taxpayer’/state allows for the estimation of cost-benefit ratios based on what we have termed the fiscal benefits of the program relative to costs. These can serve as an indication of the degree to which intervention models exist that could generate sufficient savings to permit self-funding SIBs, assuming at this level of abstraction that all fiscal savings are cashable.

As of May 2017, WSIPP had applied their cost benefit model to 343 program interventions. Table 3 summarizes information on the benefit-cost outcomes of the program interventions evaluated, with the first row examining the entire suite of interventions and subsequent rows presenting results by social program area. Of the 343 interventions analyzed, 76% of the interventions examined were predicted to generate positive public value benefits, with justice and education interventions having above average positive rates - see column 2. Overall, approximately one-in-five were expected to generate a positive net benefit with a high degree of confidence, 95% or higher, according to the WSIPP Monte Carlo simulations – results presented in column 3 - with justice interventions being the most reliable. Column 4 lists the percentage of interventions with a predicted net fiscal benefit, noting that 57% of interventions generate positive net fiscal benefits such that the savings to taxpayers were

sufficient to offset the cost of the intervention. This suggests the existence of a large potential population of suitable interventions for self-funded SIB projects.

Table 3

*Washington State Institute for Public Policy Benefit Cost Model Results*

	(1) # of Interven- tions analyze d	(2) Benefi- ts minus costs > 0 (net presen- t value)	(3) 95% or greate- r chance benefit s will exceed costs	(4) Taxpay- er benefits minus costs > 0 (net present value)	(5) # of Interven- tions with costs ≤ 0	(6) Benefi- t Cost Ratio ≥1 (wher- e cost > 0)	(7) Taxpay- er Benefit Total Cost Ratio ≥ 1 (where cost > 0)	(8) Media- n Benefi- t Cost Ratio (wher- e cost > 0)	(9) Median Taxpay- er Benefit Total Cost Ratio (where cost > 0)
<b>Total</b>	<b>343</b>	<b>76%</b>	<b>21%</b>	<b>57%</b>	<b>28</b>	<b>75%</b>	<b>53%</b>	<b>4.24</b>	<b>1.18</b>
Youth Criminal Justice	30	83%	37%	53%	4	81%	46%	3.62	0.87
Adult Criminal Justice	49	80%	45%	59%	10	79%	49%	3.71	0.99
Child Welfare	8	75%	25%	75%	2	67%	67%	9.43	3.75
Pre-K to 12 Education	50	84%	14%	66%	0	84%	66%	6.83	1.91
Children's Mental Health	25	72%	20%	48%	8	59%	24%	1.38	0.56
Health Care	36	64%	25%	42%	1	63%	40%	2.80	0.75
Substance Use Disorders	39	72%	5%	49%	2	70%	46%	4.93	0.67
Adult Mental Health	25	68%	28%	60%	1	71%	63%	3.17	1.26
Public Health and Prevention	64	78%	11%	64%	0	78%	64%	7.48	2.06
Workforce Development	10	60%	0%	30%	0	60%	30%	1.48	0.73
Higher Education	7	86%	14%	71%	0	86%	71%	13.54	4.09

Of the 343 interventions evaluated, 28 or 8% of those were found to produce a gross reduction in costs over status quo treatment, and were removed from the sample for the purpose of calculating benefit cost ratios, as listed in column 5.<sup>34</sup> Columns 6 and 7 report the percentage of interventions which generate benefit-cost ratios greater than one, and columns 8 and 9 report on the median ratio values. Removing the interventions with a predicted negative cost marginally alters the percentage

<sup>34</sup> Costs are calculated relevant to either a non-treatment group where costs are zero, or relative to “treatment-as-usual” when a new intervention is being substituted for an existing suite of services (WSIPP, 2017, p. 175). In the treatment as usual case, it is possible for the intervention to have a negative cost if the new intervention package cost less than the status quo service entitlement. Two of the 28 of these interventions where cost was lower for the new intervention resulted in a savings to taxpayers but a net cost to society; both these hypothetical interventions involved reducing prison terms by 3 months for medium and high risk offenders without additional treatment. Another two of the 28 produced negative gross benefits to taxpayers as well as negative total gross benefits, but the cost savings from the shift from the status quo outweighed these negative benefits resulting in a positive net benefit; these two projects included reduced jail time for low risk offenders and diversion from prison of individuals with mental illness. The remaining 24 produced positive net benefits.

of projects providing an overall net benefit from 76% to 75%, while those that generate a net fiscal benefit over and above their costs drops from 57% to 53%. The median net benefit value for the entire sample is 4.24, while the median value based on only fiscal benefits is 1.18. Child welfare, public health and prevention, and education all have median net benefits and net fiscal values higher than average. Overall, the WSIPP model provides support for the existence of effective social programs that are able to generate both fiscal and public value net benefits, suggesting significant opportunities for SIB implementation.

#### f) Presence of an Intermediary

Instead of a direct contractual relationship between the government and front-line service providers, commonly SIBs are distinguished from the conventional procurement model partially by the presence of a distinct coordinating entity. In the UK and several other countries, this entity is referred to as the *intermediary*. In the US, this role may be subdivided between a *transactions coordinator* and a *project manager*.<sup>35</sup>

The degree to which the intermediary is independent of the investors and service providers in practice can vary between SIB projects, from simply a legal entity or special purpose vehicle created to facilitate the project partnership, to an independent third-party organization that acts as a lead proponent for the project. In the latter case, a separate legal entity will often be established regardless, presumably to limit the legal liability of the participating non-government stakeholders. For example, in the Peterborough anti-recidivism and Essex child welfare SIBs, Social Finance UK acted as an intermediary (Social Finance, 2018) but two separate intermediary entities, Social Impact

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<sup>35</sup> The Non-Profit Finance Fund (2017) defines the role of transactions coordinator as including responsibilities may include: "design and structure of PFS project and financing model; capital raise; stakeholder management; on-going performance management" while the project manager is the "intermediary during service delivery phase, and/or fiscal sponsor for project funds".

Partnership Limited (Nicholls & Thompkinson, 2013, p. 12-13) and the Children's Support Services Limited (Social Finance, 2014) were formed as the formal legal intermediary entity.

An intermediary raises the money to finance the programming and manages the project. The intermediary is responsible for selecting the service delivery agents and provides them with upfront working capital, as previously noted solving a problem in earlier payment by result schemes. The role of an intermediary can be comparable to a general or prime contractor, but given the responsibility to raise private finance, a more accurate comparison would be with that of similar special purpose vehicles that are used in PPP infrastructure projects. Intermediaries may be competitively solicited or an intermediary may co-construct the project with government and continue into a project administration role once the SIB has been launched, the former being preferred for reasons of "transparency and legitimacy" and the potential to discover new information on program options (Azemati, Belinsky, Gillette, Liebman, Sellman, & Wyse, 2013, p. 28).

The introduction of an intermediary further distinguishes SIBs from conventional procurement, transferring activity from the state to the private sector, including responsibility for project coordination. Where the intermediary is an active proponent organization specializing in SIBs, such as Social Finance, their expertise may reduce transaction costs and bring knowledge of best practices from other jurisdictions to the project. The participation of an intermediary however will create additional expenses that will need to be covered within the project budget or from alternative sources. It has also been claimed that this intermediary will increase principal-agent problems with respect to state supervision of service provider performance (Stid, 2013). From an efficiency perspective then, the intermediary – and the SIB approach more broadly - will need to add value equal to or greater than these extra costs to justify its use.

#### g) External evaluator and control group based evaluation method

Dear et al. (2016) suggest that "measurement is what differentiates Social Impact Bonds from other contracting structures" (p. 60). Martin (2015) notes that PbC "can be thought of as a method of



translating performance accountability and performance measurement into performance specifications for use in government contracting” (p. 66). Contracting based on outcomes requires specification of by what system of account the targeted outcomes will be measured and deemed to be achieved. Based on this centrality of determining to what extent outcomes have been achieved, many SIBs utilize an independent third-party evaluator to conduct the assessment, and some definitions of SIBs include this as an essential feature – see Table 1. This evaluator is sometimes called an *independent assessor*, and is distinct from an *evaluation advisor* who may be hired to assist the group managing the SIB and provide monitoring and analytical assistance while the intervention is being delivered (Burand, 2012, p. 453 fn.9). The Nonprofit Finance Fund (2017) makes a similar distinction between an *evaluator* who is will “design and implement plan for determining whether outcomes have been met”; and the *validator* who will “verify accuracy of data used in evaluation plan, or evaluation plan itself”.

The key objective of the evaluator/assessor is to determine the impact of the intervention and separate out positive changes in outcomes overtime that that would have occurred without the intervention. This is sometimes referred to as “deadweight” and can be calculated by comparing outcomes for the program participants to administrative outcomes in an area outside of application of the intervention, or by identifying a control group who does not receive the intervention, drawn from the same population as the treatment group (HM Treasury et al., 2014, p. 31).

There are varying degrees to which the control group can be constructed to isolate the impact of the intervention on the participating population. Welsh et al. (2015) and MacKenzie and Farrington (2015) endorse the use of the previously developed “scientific methods scale” to classify the “the methodological quality of intervention studies” (Welsh et al., 2015, pp. 467-468):<sup>36</sup>

Level 1: Correlational evidence: [target outcome] correlates with the program.

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<sup>36</sup> See Morse (2015, p. 35) for a similar hierarchy of evaluation quality.

Level 2: Nonequivalent control group or one-group pre-post design: program group compared with nonequivalent control group; program group measured before and after the intervention (with no control group).

Level 3: Equivalent control group design: program group compared with comparable control group, including pre-post and experimental-control comparisons....

Level 4: Control of extraneous variables: program group compared with control group, with control of extraneous influences on the outcome (e.g., by matching, prediction or propensity scores, or statistical controls).

Level 5: Randomized experiment: units assigned at random to program and control groups.

The higher levels are more robust and permit stronger conclusions to be drawn from the evaluation evidence, with Level 3 having been recommended as the cut-off for reliability and inclusion in meta-analytical studies (Welsh et al., 2015).

The use of randomized control trials (RCT) for program evaluation has however not been without its critics. Heckman (1992) for example points out some technical limitations and conceptual challenges with RCT, such as its restriction to the analysis of mean differences, that randomization may alter participant behavior, and that most social programs are multistage in nature and randomization usually only occurs at one stage. Reddy (2012) provides a more fundamental critique to RCTs, given the mediating impact and constitutive role of the political and socio-economic context. It is not possible to isolate the impact of an intervention and assume that this impact is transferable to other contexts, either to different places or into the future. He notes that it is through comparison of these differing political and socio-economic contexts, “tracing the individual processes that are at play and recognising their commonalities, [that] one can begin to understand how and why policies do or do not work” (p. 66). Chernomas and Hudson (2016, pp. 34-36) also point to bigger-picture issues including the inability of RCT to determine the motivation or causation of behavioral changes and the limiting perspective that RCT imposes on solutions to social problems (we return to these

issues in the final chapter). Others have also highlighted the ethical concerns of denying services to an identified population in need (Loxley, 2017; Tse & Warner, 2018b).

## IV. Conclusion

This chapter laid out some foundational concepts and characteristics of SIBs, with a focus on how SIBs are differentiated from conventional procurement models. We defined SIBs as government procurement contracts enabling the delivery of some social service intervention that bundle together design, delivery and project finance, where the contract payment structure is based on outcomes. Private investment is used to finance the project, with investors facing at least some repayment and return risk based on outcomes.

SIBs represent a new frontier for publicly funded social service delivery as part of an evolving trend of increased government reliance and devolution of risk and responsibility to the private sector (Warner, 2015), bringing social public service delivery one step closer to a fully privatized model (Whitfield, 2015, p. 23). Many of defining elements of SIBs, including private finance, pay-by-results contracting, as well as bundled and contracted out design, finance and operations have been utilized before and extensively in some areas of public service delivery. It is their combination in the social service sphere that leads to SIBs being a new and unique delivery model.

SIBs are being implemented in a number of policy areas including anti-recidivism, child welfare, early childhood development, housing and homelessness prevention, active labour market programming, and public health. In this chapter, we demonstrate that a large proportion of existing social intervention models in these policy areas that have been subject to rigorous evaluation and analysis are socially beneficial from a cost benefit perspective and produce high social returns on investment. In many cases these programs have also demonstrated an ability to not only produce net social benefits but also generate fiscal savings to government greater than the cost of the program intervention. In a real sense, these interventions are providing 'something for nothing' when

compared to the alternative of not intervening or the status quo. If one accepts these results and their transferability, not proceeding with these program interventions suggests some type of collective action failure.

One challenge to the transferability of these results is connecting the results from the high-quality program evaluations to broad-based programming as it is implemented in practice. Treatment integrity – the adherence to the best practice program design model – is often much more stringently followed in experimental studies and is not well adhered to in practice. In fact, there is evidence to suggest that broad-based social programs in some areas are not delivering interventions that are even similar in kind to the demonstrated best practice. The question is then how does government allocate resources to programs that deliver on the social and fiscal potential of these demonstrated successful interventions, as opposed to those that do not generate positive results.

By paying only based on results and not requiring upfront government funding, SIBs appear to provide a solution. In Chapter Three we examine the arguments put forward as to why SIBs may help overcome these challenges, despite the fact that they face higher implementation costs than other procurement methods. But first in Chapter Two we examine in more detail the SIB landscape and their historical development, along with the network of supportive organizations and government programs that have supported their initiation and growth. In any case, whether they are the most efficient mechanism or not, the evidence presented in this chapter regarding the large number of program interventions providing fiscal and public value net benefits suggest significant viable opportunities for SIB implementation, a promising - if not sufficient - predictor of their continued proliferation.

# Chapter 2: THE SHORT HISTORY OF SIBS AND THE DEVELOPMENT OF THE ENABLING FIELD

## Introduction

While the idea behind Social Impact Bonds (SIBs) can be traced back at least as far as the 1980s (Horesh, 1988), SIBs are a relatively new model for social service delivery. The first SIB project became operational in the UK in 2010, but subsequent SIBs did not emerge until April of 2012, with six new projects in the UK. In August of 2012 the first US SIB was launched. In 2013, SIB projects were launched in Australia, Germany and the Netherlands, and in 2014 Canada and Belgium joined the small group of countries with active SIBs. By the end of 2014 these countries collectively had 30 active SIB projects. In 2015, the number of Impact Bonds increased significantly, with 22 projects becoming active, with a number of countries launching their first projects, including Austria, Finland, Israel, Portugal and Switzerland. Since 2015, an additional 38 impact bond projects have become active. Based on our survey, the total number of active SIBs worldwide has increased to 100 as of January 2018.<sup>1</sup>

SIBs are therefore a relatively recent innovation in social service delivery, and while the concept has generated interest in several countries and with various levels of government, the model is still in the early stages of implementation, in the sense that the total value of contracts is small, and few

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<sup>1</sup> In January 2018, the most widely cited sources, the SIB Database produced by Social Finance (2018), listed 108 SIB projects initiated to date. To arrive at 100, we subtracted six development impact bonds which we treat separately, and two Japanese projects which based on our research were not true SIBs as they did not have a repayable investment component and were funded through conventional means to test the potential.

contracts have reached their conclusion to date.<sup>2</sup> Various governments are actively exploring the concept and several additional SIBs are under development, with many instituting upfront state incentives to support the development of SIBs, such as programs to support outcome payments, making it likely that the number of new SIBs will continue to grow in the near future.

This chapter provides a summary discussion of the 100 Social Impact Bond projects that have reached the implementation stage as of January 2018. Data for this chapter on SIB metrics and characteristics are authors' calculations based on data compiled from Gustafsson-Wright et al. (2015), Nonprofit Finance Fund (2017), and primarily Social Finance (2018), with for more recent SIB projects being incorporated based on Bollag (2017), Elton John AIDS Foundation (2017), Numbers for Good (2017), Pidd (2017), and Ruf (2017). In Section I we present summary statistics on size of SIBs by social policy sectors based on various measures including number of SIBs, number of participants, and upfront investment in SIB projects. Section II examines the geographic distribution and emergence of SIB projects, with a focus on the facilitating institutional supports. Section III summarizes the reported results to date with respect to whether SIB projects have been meeting their targets. Section IV reviews data on investors' returns, and Section V concludes.

## I. The Scale of Impact Bonds by Sector

SIBs have been implemented in a number of policy sectors, including child and family welfare, criminal justice, education and early years, environment and sustainability, health, housing/homelessness, and workforce development. Table 4 summarizes the scale of SIB activity in the various sectors using three different measures: the number of projects, the number of

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<sup>2</sup> Only 15 completed projects were identified as having reported results as of December 2017.

participants receiving services, and the total value of upfront investment. Total participant and upfront investment numbers are based on available data and includes the vast majority of projects.<sup>3</sup>

Workforce development, which includes programs aimed at improving the labour market outcomes of target groups, has been and continues to be the largest category of SIBs since 2012, making up over one-third of the total. Other areas have been growing rapidly in more recent years, including the housing/homelessness and health sectors, which have the second and fourth highest number of impact bonds, respectively. The area of child and family welfare has seen consistent activity since 2012, and is the third most common type of impact bond, while criminal justice and education and early years have a lower but growing number of projects.

With respect to number of participants, workforce development serves the greatest number, but health and criminal justice displace housing and child welfare as the second and third largest sectors, respectively by this measure. When measured by total upfront investment, criminal justice is the sector with the greatest dollar value of investment, followed closely by workforce development.<sup>4</sup> In general, measuring the balance of activity between sectors by total upfront investment results in activity being more equally distributed between sectors.<sup>5</sup>

With respect to the size of individual SIB projects, criminal justice and health are the two sectors with the largest number of participants and dollars invested per project. Housing/homelessness has

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<sup>3</sup> Participant data was identified for 95 of 100 projects and upfront investment data for 84 of 100 projects. Those missing both include a Korean workforce development project, a UK child welfare project, a Japanese Health SIB, and a UK Health SIB. The environment and sustainability SIB did not have participants. Projects for which only investment data is unreported include one Australian criminal justice project, three UK workforce development projects, two French workforce development projects, One UK health project, one Dutch workforce development project, two UK early childhood projects, one US criminal justice project, and one German child welfare project.

<sup>4</sup> Following Gustafsson-Wright et al.(2015), SIB investment amounts in different currencies are converted utilizing exchange rates in the month of contract signing or project announcement.

<sup>5</sup> Rizzello and Carè (2016) provide a detailed review of investment and the investors in SIBs up until August of 2016. Using exchange rates as of August 30<sup>th</sup>, 2016, they calculated the total value of investments to be approximately \$196.8USM, not including grants. The data used in this chapter includes grants when identified, both recoverable and non-recoverable, that are put towards the investment capital of the SIB projects; we attempt to excluded grants that were contributed prior to the SIB launch that support the development of proposals.

the smallest number of participants per project, while workforce development and child and family welfare have the lowest upfront investment per project.

	<u># of SIBs</u>	<u>%</u>	<u># of Clients Served</u>	<u>%</u>	<u>Total Inv. \$USM</u>	<u>%</u>	<u>Clients / Bond<sup>6</sup></u>	<u>Inv.(\$ USM) / Bond<sup>7</sup></u>	<u>Avg. Term in mths<sup>8</sup></u>
Child and Family Welfare	14	14%	4,871	4%	\$55.3	15%	375	\$4.6	66
Criminal Justice	10	10%	28,195	24%	\$68.7	18%	2,820	\$8.6	63
Education and Early Years	9	9%	7,253	6%	\$27.5	7%	806	\$3.9	54
Environment and Sustainability	1	1%	0	0%	\$25.0	6%	n.a.	\$25.0	750
Health	11	11%	31,280	27%	\$55.5	14%	3,476	\$6.2	58
Housing/ Homeless-ness	19	19%	6,987	6%	\$59.6	15%	368	\$3.5	51
Workforce Development	36	36%	37,382	32%	\$66.9	17%	1,068	\$2.3	49
<b>All Sectors</b>	<b>100</b>	<b>100%</b>	<b>115,968</b>	<b>100%</b>	<b>\$358.5</b>	<b>100%</b>	<b>1,148</b>	<b>\$4.3</b>	<b>62</b>

## II. The Emergence of SIBs by Country

Table 5 presents data on the distribution of SIB activity by country of implementation, based on publicly disclosed data.<sup>9</sup> The United Kingdom continues to be a leading nation with respect to SIB development measured by number of projects, although in three of the last four years, other countries have launched more SIB projects, with the USA being a leading developer.<sup>10</sup> Together the UK and US account for 60% of all SIBs launched to date and three-quarters of all participants, with

<sup>6</sup> Denominator adjusted for projects not reporting participant data or those with zero participants, including two child welfare projects, one health, one housing, one workforce development, and the single environment and sustainability SIB.

<sup>7</sup> Denominator adjusted for 16 projects not reporting investment data, including two child welfare projects, two health projects, one housing, two health, and seven workforce development projects.

<sup>8</sup> This column reports the average length of the SIB contract in months. The average for all sectors with the exception of environment and sustainability, which is an outlier, is 54 months.

<sup>9</sup> Figures in table totals based on available data. Not all projects have publicly disclosed data on number of participants and total upfront investment – see footnote 2. Korea, Japan and the UK are underrepresented in the both investment and participant categories due to missing data, while France and Germany are under-represented in the investment category.

<sup>10</sup> The UK would have led most recently if the 10 SIBs announced late in 2017 in the UK funded by the Life Chances fund were included, however these projects had not yet identified investors and there was ambiguity regarding whether these projects would proceed as SIBs (see: Ainsworth, 2017).



approximately 86,500 participants collectively. Canada and Australia, the next two leading countries by number of participants, by comparison, have less than 8,000 participants each. The average number of participants in SIB projects has been 1,221, lower but comparable to the UK average of 1311, while the US is delivering larger sized-projects on average, with 1,930 participants per project.

When measured by total upfront investment in SIBs, the US and the UK continue to collectively dominate, making up 77% of total investment in SIBs, but it is the United States who is the leader, with just under 60% of total market share. The investment per project in US SIBs dwarfs those of the UK, with US projects averaging \$11.0USM, while UK projects on average are based on \$2.1USM in investment. This is likely due to the prevalence of workforce development SIBs in the UK, which makes up 39% of UK SIBs,<sup>11</sup> with workforce development SIBs having the smallest average dollar value and contract length, likely reflecting a lower degree of intensity of the intervention.

Country	# of SIBs	# of Clients Served	% of Total	Total Investment (\$USM)	% of Total	Average # of Clients/ Bond <sup>12</sup>	\$USM Inv. / Bond <sup>13</sup>
Australia	7	7,690	7%	\$36.5	10%	1,099	\$6.1
Austria	1	75	0%	\$0.9	0%	75	\$0.9
Belgium	1	180	0%	\$0.3	0%	180	\$0.3
Canada	4	7,510	6%	\$5.5	2%	1,878	\$1.4
Finland	2	4,300	4%	\$12.0	3%	2,150	\$6.0
France	2	1,500	1%	n.a.	0%	750	n.a.
Germany	2	148	0%	\$0.4	0%	74	\$0.4
Israel	2	2,850	2%	\$7.6	2%	1,425	\$3.8
Japan	2	100	0%	\$0.3	0%	100	\$0.3
Netherlands	8	2,530	2%	\$11.8	3%	316	\$1.7
New Zealand	1	1,700	1%	\$1.2	0%	1,700	\$1.2
Portugal	4	611	1%	\$2.0	1%	153	\$0.5
South Korea	2	100	0%	\$1.0	0%	100	\$1.0
Sweden	1	60	0%	\$1.2	0%	60	\$1.2
Switzerland	1	120	0%	\$0.3	0%	120	\$0.3
UK	40	49,829	43%	\$68.1	19%	1,311	\$2.1

<sup>11</sup> See Appendix B for a breakdown of sector proportion of SIBs by country.

<sup>12</sup> Denominator adjusted for projects without participant data, including one Japanese, one South Korean, two UK, and one US.

<sup>13</sup> Denominator adjusted for 16 projects not reporting investment data, including one Australian, one Dutch, two French, one German, one Japanese, one South Korean, eight UK, and one US.

USA	20	36,665	32%	\$209.5	58%	1,930	\$11.0
<b>All SIBs</b>	<b>100</b>	<b>115,968</b>	<b>100%</b>	<b>\$358.5</b>	<b>100%</b>	<b>1,221</b>	<b>\$4.3</b>

While SIBs currently only make up a miniscule proportion of overall social expenditure,<sup>14</sup> the number of SIBs being released continues to trend upwards, with the last three years, 2015-2017, being the highest three for the number of SIBs launched since their introduction in 2010. Figure 8 summarizes the annual growth rates from 2013 to 2017 in SIBs by total number of projects launched, participants and funds invested. While there has been a downward trend from very high initial growth rates for investment in 2013, and the peak growth rates for the number of projects and participants in 2015, annual growth rates remain strong in more recent years, in the 14% to 72% range. There are a significant number of SIB projects currently in development, with an estimated 100 projects in the United States alone, and at least another 100 worldwide (Social Finance, 2018), suggesting that growth rates will continue to remain positive.

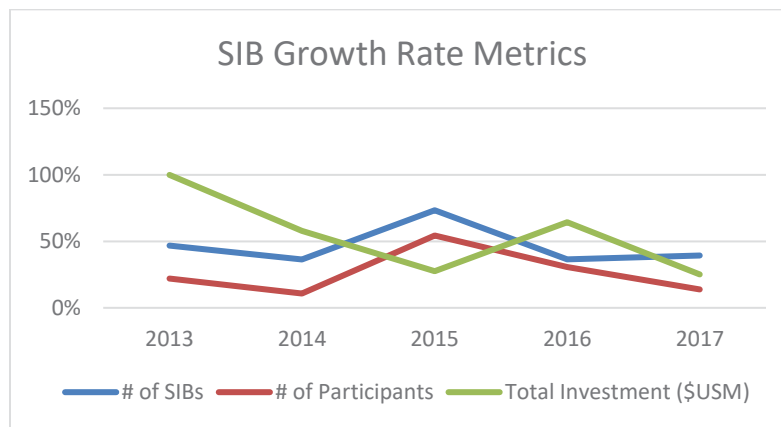


Figure 8: SIB annual growth rate metrics

<sup>14</sup> Floyd (2017, p. 3) estimated that total contract value of all SIB projects represented less than 0.1% of total US government social spending, and less than 1% of Pay-by-Results contracts in the United Kingdom.

## The Concept of 'Enabling Field'

The initiation of the SIB model and its subsequent expansion has been buttressed by a suite of initiatives supported by governments, academic institutions, and non-profit organizations. Heather Whiteside (2013), building on Jooste and Scott (2012), utilizes the concept of “enabling fields” (p. 86) to describe the system of institutional supports in the Canadian context to promote public private partnerships (P3s) in infrastructure, including the development of new practices and dedicated organizations both outside and within government. These include “important changes within government made to... planning procedures and bureaucratic decision-making, and new forms of institutional support... [that] normalize P3 use through the routinization, institutionalization, and depoliticization of this policy” (p. 86). A similar phenomenon has occurred with the emergence of the SIBs, one of many similarities between the two procurement contracting models.

The short history of SIB emergence demonstrates an abundance of institutional supports to experiment with and implement the model in terms of proponent institutions, government policy, dedicated funding (Dear et al., 2016, p. 35), and in some countries, legislation. Public sector programs have subsidized the design of the SIB as a concept and specific SIB contracts, with investment being supported through tax credits, guarantees, and by topping-up outcomes payments, with all four present in the UK and all countries with SIBs utilizing at least one of these types of supports (Floyd, 2017, p. 14). Outcome funds have been particularly prevalent, with the UK issuing just under £200m for this purpose, leading “to a pipeline of over 60 potential future transactions”, with supports in several countries also aimed at assisting organizations to increase their capacity to participate in SIBs (Dear et al, 2016, p. 48). Below we review the evolution of SIB activity in the UK, US, Australia, Canada, Europe and Asia, and outline the supports that have been made available for SIB development.

## a) United Kingdom

The first SIB launched was an anti-recidivism project implemented for adult offenders serving short-term prison sentences at HM Prison in Peterborough, UK, commissioned by the UK Ministry of Justice, in September 2010 (Disley & Rubin, 2014).<sup>15</sup> The Peterborough anti-recidivism SIB was developed as a result of a 2007 call from Gordon Brown's Labour government for ideas to promote public-private partnerships to addressing social issues in the UK (Eames, Terranova, Battaglia, Nelson, Riesenber, & Rosales, 2012, p. 7) and subsequently advanced by the Labour government's Council on Social Action (Whitfield, 2015, p. 7). The investment capital was based on contributions from 17 foundations and trusts, some explicitly focussed on inserting social values in financial markets and addressing social disadvantage, as well as some with broader mandates.<sup>16</sup> The main stakeholders involved in the project included the Big Lottery Fund and the UK Ministry of Justice as the outcomes funders, and Social Finance Ltd., a UK non-profit, was the lead proponent for the project.

There was a year and a half delay prior to additional SIBs becoming operational, with six SIBs focussed on youth employment launched in April of 2012. At this point the UK was still the only country to have active SIB projects. November 2012 saw the next UK tranche of SIB projects, with a second round of four UK youth employment projects. November 2012 also saw the launch of two additional SIBs backed by municipal government payment commitments in addition to the UK government, in the area of housing and homelessness prevention, and the first SIB in the area of child welfare (Dowd, 2013). By the end of 2012, the UK had 14 SIB projects operational, with only the US

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<sup>15</sup> See Nicholls and Tomkinson (2013) for a detailed case study of the HMS Peterborough SIB project. In 2014 the UK government cancelled the last of three planned cohorts in the Peterborough SIB project due to the introduction of the Transforming Recidivism initiative, a more expansive partial-privatization scheme for anti-recidivism programming in England and Wales, based on a payment-by-results compensation structure. See Ministry of Justice (2014) for further details on the Transforming Recidivism initiative.

<sup>16</sup> The full list of names investors included: Barrow Cadbury Trust, the CowPat Trust, Esmée Fairbairn Foundation, Friends Provident Foundation, Golden Bottle Trust, The Henry Smith Charity, the Hintze Family Charitable Foundation, J Paul Getty Jr Charitable Trust, Johansson Family Foundation, K L Felicitas Foundation, LankellyChase Foundation, Monument Trust, Panahpur, Paul Hamlyn Foundation, R&S Cohen Foundation, Rockefeller Foundation and the Tudor Trust (Barrow Cadbury Trust, 2017). Many of these foundations would go on to invest in subsequent SIB projects. See Chapter 5 for further discussion and analysis of investors in SIBs.

having a single operational SIB outside of the UK, and the UK continues to be the leader today with 40 projects initiated as of December 2017.

The United Kingdom government has been a leader in the promotion of development and financial supports for SIBs, with the government itself acknowledging the substantial public resources that have been invested in constructing the SIB market (Cohen, 2013). UK government support for SIBs fit well with Prime Minister's Cameron's "Big Society" vision, based on displacing "big government" through the localization of government service provision and a greater reliance on community, volunteer and non-profit organizations (Cohen, 2013; Coote, 2011, pp. 1-2). The 2011 Open Public Service White Paper, aimed at focussing and disseminating the new government's vision for public sector reform, further articulated this approach, with several references to the utilization of SIBs specifically and a broader emphasis on restructuring public service delivery towards payment by results, noting that "open commissioning and payment by results are critical to open public services" (HM Government, 2011, p. 29). The government also established an interdepartmental group of staff, which operated from 2010 to 2014, to support the promotion and implementation of PbR and worked to "identify public services where government could make further use of PbR" (Morse, 2015, p. 16).

The UK government's promotion of impact bonds has not been limited to the national stage: PM Cameron advocated and later utilized his presidency of the 2013 G8 meetings to host a social impact investment forum which included a session on SIBs (Amhed, 2013; Cabinet Office, 2013), and the UK continues to be involved in the promotion of Development Impact Bonds through its international development agency (Department for International Development, 2014; Saldinger, 2017).

Numerous UK public sector dedicated funds have been established and used to support the delivery of SIBs. These include the Commissioning Better Outcomes and Cabinet Office Social Outcomes funds, though which the Big Lottery Fund and the UK Government has allocated between

£40M and £60M for SIB projects (Floyd, 2017). The Department for Work and Pension's £30M Innovation Fund, designed to bolster the social investment market and promote SIBs in the area of youth employment, contributed outcomes payments to 10 SIB projects (Insite Research and Consulting 2014, p. 10). The Cabinet Office Youth Engagement Fund provided an additional £16M for youth education and training SIBs (Cabinet Office, 2014). In 2014 the government introduced the 30% Social Investment Tax Relief (SITR) tax credit for which SIB investments by individuals are eligible, resulting in some cases a more than doubling of effective returns to investors (Floyd, 2017). The government also created two dedicated homelessness prevention SIB outcome funds, the Fair Chances Fund in 2014 and the subsequent Rough Sleeping SIB Fund in 2016, which collectively dedicated £25M in outcome payments through the Cabinet Office & Department for Digital, Culture, Media and Sport (DCMS; 2017). More recently the UK government launched the £80M Life Chances Fund to support up to 20% of outcomes payments for new SIB projects, with the expectation of leveraging an additional £320M in outcomes payment from local governments (Cabinet Office, 2017). Floyd (2017) estimates that from 2010 to 2016, the subsidies provided by UK government and quasi-government agencies to support the development and implementation of SIBs totaled £44.7M, which exceeded his estimated £38.9 of private investment in UK SIBs (p. 16). This is in addition to paid and anticipated outcome payments. Assuming that on aggregate SIBs pay back at least their invested capital, this implies that the UK government and its arms-length agencies would will have paid out £2 for every £1 invested in direct service delivery.

In addition to grant and outcome payments based on direct public funds, the UK government has established Big Society Capital, a social investment fund seeded with dormant bank account funds, with links back to the Conservative's 2010 general election platform (Stott, 2011, pp. 2-4). The Fund is an independent corporation, supplemented with investment from the shareholder banks of Barclays, Lloyds, RBS and HSBC, whose control of the corporation is limited to 40%. Big Society Trust, a sister organization, holds the remaining shares. Each organization is entitled to voting rights based

on share ownership, but the banks have agreed to collectively limit their voting rights to 20% (Big Society Capital, 2017). Big Society Trust continues to receive a new investment capital through England's share of dormant bank account funds (Big Society Capital, 2017). Big Society Capital has invested in seven UK SIBs as of January 2018 (Social Finance, 2018).

SIBs in the UK have also benefited from the development of proponent organizations that have acted as technical assistance providers and intermediaries on SIB projects, many supported directly in their efforts by the UK government. Social Finance, incorporated in 2007 as a non-profit, is arguably the leading global proponent of SIBs and the "policy entrepreneur" (Kingdon, 2005, p.179) behind the SIB model. Overseen by a board with financial sector representatives, the organization is focussed on Pay by Results (PbR) and outcomes-based financing models for social service delivery for vulnerable populations, with their website highlighting over £100M in leveraged investment. Since 2010, the organization has acted as the intermediary in 10 UK SIBs (Social Finance, 2018) and has received at least £11.25M in public support for its intermediation activities in the UK (Floyd, 2017). Social Finance was the organization that drove the creation of Big Society Capital, with several founding members having served on the UK Government's Commission on Unclaimed Assets, including the chair Sir Richard Cohen (Warrell, 2008). Social Finance continues to be a leading global proponent of SIBs, with satellite organizations in the United States and Israel, and establishing a network of partners in other countries and regions including Canada, South Africa, Ireland, and Latin America (Social Finance, 2016a). The organization has published numerous reports and technical assistance documents to support the development of SIBs and maintains a detailed database of impact bond projects in progress and under development.

The Young Foundation was an earlier promoter of the potential of the SIB model supporting research and development efforts in both in the UK and Australia (Mulgan et al. 2011; Shergold, Kernot, & Hems, 2011). Prevista is unique as "one [of the] very few private companies to act as a

social investor, intermediary and managing agent on payment by results contracts” and has worked on developing SIBs outside of the UK as well (Prevista, 2017).

Within DCMS, the Centre for Social Impact Bonds was established in 2016 to “provide expert guidance on developing SIBs, share information on outcomes-based commissioning and support the growth of the social investment sector... in partnership with a range of stakeholders, including local commissioners, service providers, academics, social investors, intermediaries and departments across government” (Cabinet Office & DCMS, 2017). The Centre has also partnered with Oxford University’s Blavatnik School of Government to create the Government Outcomes Lab (GO Lab), a technical assistance provider that provides one-on-one support to organizations initiating SIBs and other PbR contracts.

The UK government has also been a leader in creating tools and undertaking systems change to facilitate the use of SIBs and other PbR tools. For example, the government partnered with the organization New Economy (2015) to develop the Unit Cost Database, which was jointly “quality assured” and provides a guide to quantifying costs and savings of various social interventions (Cabinet Office & DCMS, 2017). The government also supported the development of *rate card* systems aimed at facilitating the SIB process, allowing multiple contracts to be issued in the same policy area more effectively and reducing the amount of evaluation required. Rate cards set fixed payments based on a per outcome basis for multiple outcomes and set a standardize evaluation process, allowing faster implementation of SIB projects across several service providers and geographic regions (Social Finance US, n.d.). The UK government developed and utilized rate card systems for SIB projects funded through the Innovation Fund, the Youth Engagement Fund, and the Fair Chances Fund (Gustafsson-Wright et al., 2015, p. 18). The government also made legislative amendments through the Charities (Protection and Social Investment) Act of 2016 that enabled charities to make “social investments...that pursue both a financial and social return” (Cabinet Office, 2016, p. 4), including SIBs (pp. 18-19).



Based on this infrastructure of support, the UK is the undisputed pioneer in the development of SIBs. The government continues to drive the model, recently announcing £16 million in outcomes payment funding for 10 new SIBs through the Life Chances fund (Cabinet Office, 2017).<sup>17</sup> In late 2017 the Life Chances Fund also approved 41 separate grants to support the development of new or expanded SIB projects (GO Lab, 2017). The UK will likely continue to be a leader for some time to come.

## b) United States

While the UK is the undisputed SIB pioneer, its rising and nearest rival is the US. In August of 2012, New York City partnered with Goldman Sachs and Bloomberg Philanthropies to deliver the first municipally-issued SIB and the first SIB project in the United States, aimed at reducing recidivism (Olson & Phillips, 2013). This SIB was unique in that a substantial proportion, \$7.2M of the \$9.6M private sector investment was backed by a loan guarantee from Bloomberg Philanthropies (Nonprofit Finance Fund, 2017; Olson & Phillips, 2013), which in the end was executed.<sup>18</sup> It was over a year after the start of the Riker's Island SIB when the second US SIB launched, the Utah High Quality Preschool Program, in September of 2013, and another five projects would be established by the end of 2014. While 2015 saw only one project established, another 12 projects were launched by January 2018, for a total of 18 projects. The US now has the second most SIB projects and as noted above is the world leader in upfront funds invested.

Like the UK, SIBs in the US have received financial and promotional support from the national government. In 2009 the Obama administration established the Office for Social Innovation and Civic Participation (OSICP), with a mandate to seek a more effective allocation of social service funding

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<sup>17</sup> It is unclear if investors have yet been identified or when programming will begin (Ainsworth, 2017), so these projects are not included in this chapter's SIB statistics reported above.

<sup>18</sup> This SIB would eventually fail to meet its targets and be ended prior to its scheduled end date, resulting in \$6.0USM of Goldman's \$7.2USM in funds invested to that point being paid back by Bloomberg Philanthropies, generating significant discussion and introspection regarding the implications of the results (Anderson & Phillips, 2015; Cohen & Zelnick, 2015; Milner, Poethig, Roman, & Walsh, 2015; Vera Institute of Justice, 2015). This is the only SIB to our knowledge that has publicly announced a failure to meet targets and outcomes payments not being released.

and support a focus on outcomes. In 2011, OSCIP organized a national conference titled “Pay for Success: Investing in What Works,” (Lake, 2015, p. 77) and went on to become a leading voice for Pay for Success (PFS) projects, assembling approximately \$100M in support for project development (OSICP, 2016). This included \$24M through the Department of Labor (2013) that issued grants to New York State and the Commonwealth of Massachusetts to support outcomes payments for SIB projects (US Department of Labor, 2013; Nonprofit Finance Fund, 2017). It also included approximately \$12M in support through the Corporation for National Community Service’s (CNCS) Social Innovation Fund for “Pay for Success planning, feasibility studies, deal structuring, and pipeline development to help grow the field” (White House, 2016, p. 1). This funding supported several leading proponents and facilitators of SIBs in the US, many of whom later served as intermediaries and technical assistance providers on projects.<sup>19</sup> The Obama administration also attempted twice to establish a \$300M PFS outcome fund through the budget process, to match local and state government payments (Greenblatt & Donovan, 2013; White House, 2016).

At the federal level, legislation that would have enabled outcomes payment partnerships with states passed the House but was referred to the Senate Finance Committee in 2016 and has not proceeded (Library of Congress, 2017). Of the 24 US states identified as examining the employment of SIB projects, 11 of those states had passed legislation to support their implementation (Hathaway, 2016). The majority of these legislative efforts are sector specific, and range from enabling frameworks to develop the model and work with technical assistance providers, to dedicated funds to support contracts, with seven of the legislative efforts including dedicated funding sources to support SIBs and PFS projects. Some of these initiatives involve substantial associated resources.

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<sup>19</sup> Organizations that received funding from this source included the Corporation for Supportive Housing, Harvard Kennedy School Government Performance Lab, Local Initiatives Support Corporation, National Council on Crime and Delinquency, Sorenson Impact Center at the University of Utah’s David Eccles School of Business, Social Finance USA, and Third Sector Capital Partners (CNCS, 2017), all of whom had formal roles in US SIB projects (Nonprofit Finance Fund, 2017). The Institute for Child Success also received funding and has undertaken a number of feasibility studies for PFS projects (Institute for Child Success, 2017).

Legislation in Massachusetts enacted in 2012, for example, authorized up to \$50USM in PbR outcome payments with “the “full faith and credit” of the Commonwealth” (Liebman & Sellman 2013, p. 25).

Several state and local governments have also contributed resources to cover program costs not covered by investors, over and above outcomes payments, including California, the City of Denver, Colorado, Los Angeles County, Massachusetts, Santa Clara County, South Carolina, and Utah. Several of these include covering housing costs for participants, which are presumably not an insignificant proportion of total project expenses.

Several organizations in the United States have been actively promoting the use of PfS and SIBs. Social Finance’s US arm has been active as the intermediary on five US SIB projects and has provided technical assistance on another (Nonprofit Finance Fund, 2017). It also received a federal grant from the CNCS’s Social Innovation Fund to develop rate cards with several state and local governments (Social Finance US, n.d.). The Non-profit Finance Fund, a social finance organization, maintains the [payforsuccess.org](http://payforsuccess.org) website which houses an extensive and detailed database on investors, outcomes payors, technical assistance providers and the structures of US PfS projects, and has invested in five projects and given grant funds to another (Nonprofit Finance Fund, 2017). Third Sector Capital Partners, a non-profit PfS intermediary and technical assistance provider, has partnered in five US active SIBs and claims to have supported the development of at least 18 other PfS projects, mobilized \$40 Million from the private sector, and leveraged \$100M in public sector funds (Third Sector Capital Partners, 2017). The Harvard Kennedy School, through its Government Performance Lab and SIB Lab, has provided similar research and technical assistance services (Harvard Kennedy School, 2017), including an *SIB Guide for State and Local Governments* (Liebman and Sellman, 2013). For-profit investors also appear to be more systematically structuring their support, with the announcement of a \$10USM fund dedicated exclusively to PfS project finance (Reinvestment Fund, 2017). Given this growing and intensive infrastructure, and an estimated 100 additional projects in development (Social Finance, 2018), the SIB Market in the US is likely to continue its expansion.

### c) Australia

Australia is the third highest country with respect to upfront funds invested in SIBs, and fourth with respect to number of SIBs and number of participants. The first Australian SIB, or Social Benefit Bond – an equivalent term utilized in Australia, was launched in 2013, targeted to successful reintegration of children, taken into care by child welfare authorities (Donaldson, 2015). Shortly after, a second child welfare SIB began, also in the state of New South Wales (NSW; Loxley, 2017). Subsequent SIBs were not launched until the summer of 2016, with two projects, one in the area of homelessness prevention and the second in criminal justice. Three additional projects were launched in 2017, in the area of child welfare and health, for a total of seven projects (Social Finance, 2018).

Australian SIBs have adopted an investment model based on open calls for investors to purchase actual bonds, unlike the practice elsewhere. This has led to the public release of investors' memoranda, and annual investors' reports publicizing the progress in meeting SIB projected performance criteria and specifying returns to date to the investors.<sup>20</sup> Although yet to occur, this raises the possibility of marketing the bonds, so that the Australian SIB market is the nearest to a tradable market in SIB investments.

The Government of NSW played a leading role in the first two Australian SIBs, coordinating their development and providing substantial guarantees to investors including full repayment guarantee plus an outcome-based return for certain investors (Floyd, 2017, p. 15, Loxley, 2017, p. 20). Australian governments have also been leaders in supporting stakeholders in developing their ability to participate in SIB projects (Dear et al., 2016, p. 48). The government of Queensland, for example has recently established a \$1AUM "Social Benefit Bonds Readiness Fund" (Rose, 2016), and the NSW government has a dedicated Office of Social Impact Investment, "a joint team of the NSW Department

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<sup>20</sup> See Benevolent Society (2013), Office of Social Impact Investment (2017), and Social Ventures Australia (2013, 2017) for samples.

of Premier and Cabinet (DPC) and the NSW Treasury... to work with its partners and facilitate growth in the social impact investment market” (Office of Social Impact Investment, 2017).

As in the UK and US, SIBs have benefit from non-profit proponent organizations. Social Ventures Australia (SVA) is an independent non-profit organization established in 2002 by former “senior Macquarie bankers” (Rose, 2016) and supported by the investment of four charitable funders and non-profit service providers to support and improve social service outcomes and engagement with social finance through technical assistance and financing (SVA, 2017; SVA, 2013, SVA, 2018). SVA has been an active promoter of SIBs and four of the six SBBs have been intermediated or coordinated by the organization (Social Finance, 2018).

The Centre for Social Impact (CSI), a tri-university research and teaching consortium founded in 2008 on government, corporate and foundation support (CSI, 2017), has played a role in the development of SBBs. In 2011, CSI undertook a feasibility study funded by the state government examining the potential to introduce the SIB model in New South Wales (NSW), including an assessment of what social service sectors might be suitable, potential investors and service providers, and estimated cost savings (Office of Social Impact Investment, 2017; Shergold, Kernot, & Hems, 2011). The report concluded that the state government should proceed with development, “encourage the development of a pipeline of NPOs [non profit organizations] and programs that are suitable for an SIB by raising awareness and developing NPO capacity and capability to use this new method of funding; ... undertake initiatives to raise awareness across all NSW Government agencies and develop guidelines on how to assess the suitability of policy areas, program interventions and host NPOs; ... [and] also explore the potential for the application of SIBs in policy areas where there is a shared responsibility and shared funding arrangements with the Australian Government” (p. 11). In September 2012, the Centre brought together public, private, and international SIB stakeholders at its “inaugural Social Finance Forum” around the same topic and to reinforce planning underway for the first SBB (Loxley, 2017; Tomkinson, 2012).

Australia has at least four SIBs in development with service providers identified, in the policy areas of housing, health and criminal justice, which were targeted for launch in 2017, and another four in the conceptual phases, with service providers yet to be identified, and targeted for launch in 2018 (Social Ventures Australia, 2017, p. 9). Given the above activity and government-supported proponent infrastructure, it is likely that the SBB market in Australia will continue to expand.

#### d) Netherlands

The Netherlands has commissioned the third highest number of SIBs with eight projects to date, with the fourth largest total upfront investment, at \$11.8 USM. Seven of these projects have been in the area of workforce development, an area that the Netherlands has large scale previous experience with in PfS procurement (Finn, 2008). The eighth, an anti-recidivism program, is also heavily focussed on employment and training.

The first Dutch SIB was launched in 2013 in Rotterdam and was coordinated by the Society Impact Platform, a special purpose intermediary organization focussed on the development of impact bonds in the Netherlands (Society Impact, 2017).<sup>21</sup> Earlier in 2013, Society Impact Platform and Ernst and Young released a working paper, partially funded by the Ministry of the Interior and Kingdom Relations, and the Minister of Social Affairs and Employment, to form the informational basis for the use of SIBs in the Dutch context (Lunes, Frissen, Vermeer, Revenboer & Anton, 2013). The report concluded with a recommendation for further study and the implementation of SIB pilots in the Netherlands (p. 45).

ABN AmRO and the Start Foundation have been two other lead proponents of SIBs in the Netherlands, and each participated in five Dutch SIB projects. ABN AmRO is a Dutch bank with a dedicated Social Investment Fund through which it has supported SIB projects (ABN AmRO, n.d.). The bank promotes SIBs through its website, publications and other public engagement activities, and

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<sup>21</sup> Society Impact was also the intermediary on a subsequent SIB in Utrecht.

also acts as a broker for government representatives, investors, and past SIB participants (ABN AmRO, n.d). The Start Foundation, who provides similar support for SIBs in the Netherlands, is a “Venture Philanthropy Fund” that provides both repayable and non-repayable support to social programming aimed at integrating the disadvantaged into the workforce. (Start Foundation, 2016a). The Start Foundation has published various tools to support SIB development including fact sheets on the SIBs it has participated in and an SIB project planning guide, and also planned and hosted a national conference on SIBs in 2015, opened with a message from the Minister of Finance (Start Foundation, 2016b).

#### e) Canada

Canada has launched four SIB projects, tying it for fifth highest, and is seventh highest in upfront funds invested in SIBs, but is the fourth highest in total number of participants, primarily due to a single health project with 4,000 participants. The first SIB in Canada, launched in 2014 and commissioned by the Province of Saskatchewan, was a relatively small project focussed on keeping 22 children, who were at-risk of coming into care, with their mothers (Loxley, 2017). In 2016, Saskatchewan launched a second SIB, in the area of education, and the federal government also launched two SIB projects in the areas of health and workforce development, with programming spanning Ontario, Saskatchewan, British Columbia, and Quebec (Social Finance, 2018). Total upfront investment in Canadian SIBs is valued at \$5.5USM, leading to a much smaller average project size than the US or Australia, but comparable to the UK.

The lead non-government proponents of SIBs in Canada have been Deloitte and the MaRs Centre for Impact Investing. In 2012, Deloitte published an information resource targeted at stakeholders to help prepare them for participation and “the arrival of the Social Impact Bond in Canada” (Deloitte, 2012, p. 1), and Deloitte has continued to promote SIB investment potential to Canadian investors through staff associated with Deloitte’s P3 and other public-sector work (MacDonald, Wenban &

Ciufo, 2014). In 2014, Deloitte co-authored a report with MaRS examining investor attitudes and interest in engaging in SIBs in Canada (Ciufo & Jagelewski, 2014), and MaRS is currently the intermediary in one of the active Canadian SIBs.

While SIB infrastructure is not as well developed in Canada as the above four leaders, there is some indication that more Canadian SIBs are to come. The Province of Ontario has a number of projects in the developmental stage, the Province of Saskatchewan has one project in development, and the Province of Manitoba has recently hired MaRS to launch its first SIB (Loxley & Hajer, 2018).

#### f) Portugal

Portugal is tied with Canada with the fifth highest number of SIBs, although the total amount invested in SIBs to date is relatively modest at \$2USM. Projects to date have been in the fields of education and early childhood development, workforce development and child and family welfare. SIB development in Portugal has been led by the Laboratório de Investimento Social (Social Investment Lab), who has been the intermediary in all four of Portugal's SIBs and offers a program for Masters' students wishing to study SIBs and generate feasibility studies as part of their research (Laboratório de Investimento Social, 2017a). The organization is a partnership of the Calouste Gulbenkian Foundation, who also financed the country's first SIB project, the IES Social Business School, an organization formed in 2008 to promote social entrepreneurship (IES - Social Business School, n.d.), and Social Finance UK, with which the current leader of the Social Investment Lab was previously stationed. (Laboratório de Investimento Social, 2017b). Portugal has also been identified as a country with generous government support for building the capabilities of organizations to engage in SIBs (Dear et al., 2016, p. 48).



## g) Finland

Finland has only two SIB projects active to date, but one is a relatively large project in the area of workforce development, launched in 2017, with €10.0M in upfront investment. This project is unique in that the investor is a public-sector entity, the European Investment Fund of the European Investment Bank Group (Ministry of Economic Affairs and Employment, 2017).<sup>22</sup> SIBs were introduced into Finland by SITRA (Ministry of Economic Affairs and Employment, 2017), also a publicly-resourced investment fund, focussed on innovation, founded based on an endowment by the national government (SITRA, 2017). SITRA served as the intermediary and as an investor in the first Finnish SIB in 2015 (Social Finance, 2018). The growth in the SIB market in Finland is expected to be high. At the municipal level, there are “approximately 30” SIB projects in development in various sectors (Keltanen, 2017).

## h) Israel

Israel has launched two SIBs to date, a \$2.1USM higher education project commissioned in 2015 and a \$5.5USM healthcare SIB launched in 2016. Both SIBs are unique in that the outcome payments are being funded by arms-length organizations, a university in the first case, and healthcare and quasi-public non-profit insurance entities in the second, as opposed to government directly. The development of both SIBs was led by Social Finance Israel, the Israeli branch of the UK-based organization, which served as the intermediary in the projects and offers similar services to its counterparts in the UK and the US.

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<sup>22</sup> The European Commission is also supporting the development of social impact bonds (Whitfield, 2015, p.8), and has committed “to facilitate the exchange of experiences between Member States with social impact bonds” (Davis, 2014, p.1).

## i) France

In March 2016, after initially avoiding SIBs due to concerns regarding privatization, France's national government issued a call for proposals on "les contrats à impact social" (CIS; Mair, 2016). Later in 2016, France's first CIS projects were announced, commissioned by the Ministry of Economy and Finance. Two workforce development projects were announced, one in rural France and one in low-income urban neighbourhoods, both centred on microcredit (Social Finance, 2018). One of these projects is supported by investment from la Caisse des Dépôts, a public-sector lending institution. A further three projects are in development in the areas of child and family welfare and youth employment (Le portail de l'Économie, 2016).

Key players in the lead up to the first French SIBs include Mirova, the "responsible investment division" of Naxis, a large multinational asset management firm (Mair, 2016), and vice-president of the Credit Cooperatif, a French credit union, Hughes Sybille, who co-chaired a French government committee on social investment and authored a report recommending the pursuit of SIBs (Mair, 2016). Neither Mirova or Credit Cooperatif however ended up investing in these initial SIB projects; this was taken up by IMPACT Partenaires, a social investment company, other traditional lenders, and a foundation. l'Institut de l'entreprise, a French think tank, also played a role in the lead up to SIBs in France, publishing an extensive report on the potential for SIBs in the French context (Pendeven, Nico, & Gachet, 2015).

## j) Germany and Austria

Germany and Austria have together each commissioned three SIBs to date, each first in the area of workforce development. The first German SIB was commissioned by the Bavarian State Ministry of Labour and Social Affairs and Family and Integration based on €0.3M of upfront investment, the Austrian SIB by the Federal Ministry of Labour & Social Affairs & Consumer Protection with €0.8M of investment. Both SIBs were initiated by the Juvat gemeinnützige GmbH, a non-profit subsidiary of the Benckiser Foundation that has been promoting the SIB model via its research and development

activities (Benckiser Foundation, 2016), and both invested in and was the intermediary for the initial SIB projects. Late in 2017, Germany launched a child welfare SIB in the district of Osnabrück (Ruf, 2017).

#### k) Japan

Japan launched its first two SIBs in April of 2017, both in the policy area of health (Social Finance, 2018). The first was commissioned by Kobe City and is being led by the Japan Social Impact Investment Foundation (Reuters, 2017); the second commissioned by Municipal government of Hachiojia (Daily Manila Shimbun, 2017). SIB prototype projects have been operational in Japan since 2015. The Nippon Foundation for Social Innovation initiated three trial SIB-style projects in 2015 focussed on adoption, dementia prevention, and youth employment, although these projects were not technically SIBs as the funding was not based on a PbR model (Nippon Foundation, 2015). The projects were funded directly by the foundation, which also acted as an intermediary to demonstrate the feasibility of SIB-type interventions focussed on prevention, outcomes tracking and evaluation. Another SIB prototype project, funded by Goldman Sachs, was launched in 2016 targeting disadvantaged youth (Tsukamoto, 2017). All four of these prototype projects were at the municipal level and had all the elements of an SIB with the exception of investor repayment. At least one additional Japanese SIB is in the planning stage, with a project in Yokohama being pursued by the UK-based Prevista and Meiji University (Prevista, 2017).

#### l) Korea

South Korea was the first Asian country to adopt the SIB model, where it was pioneered at the municipal government level. The Seoul Metropolitan Government passed the Seoul SIB Act in March 2014 and in October 2015 launched the first Korean SIB focussed on child welfare services, with Pan-Impact Korea serving as the intermediary (Pan Impact Korea, n.d.-b). Pan-Impact Korea, is an SIB proponent group, organized as a limited liability corporation that offers various services focussed on SIB implementation to government and other stakeholders. While it was formed only recently, in

2015, the organization notes that its members have been active in lobbying for SIB-enabling legislative policy as far back as 2011(Pan-Impact Korea, n.d.-a). They serve as the secretariat to the Social Impact Bond Local Government Council of Korea, which “provide[s] consultations about SIBs and introduction of related policies, as well as to build partnerships between local governments” (Pan-Impact Korea, n.d.-a). They also provided technical assistance on South Korea’s second and only other SIB to date commissioned by the Gyeonggi Province (Pan-Impact Korea, n.d.-a).

#### m) New Zealand

New Zealand has one operational SIB in the area of workforce development that became active in 2017 (Social Finance, 2018). Introduction of the SIB model into New Zealand appears to have been led by the national government, without a strong external proponent driving the process, unlike most other countries engaged in SIB activities. In 2013 the government approved pursuing the model and seeking interest from investors and other stakeholders, and engaged KPMG to develop a “business case” for a New Zealand social bonds pilot” (Office of the Minister of Health, 2013, p. 4). Over the next two years various activities were undertaken to generate interest and solicit proposals (Ministry of Health, 2017). New Zealand launched its first SIB project in early 2017, a workforce development project focussed on individuals facing mental health challenges (Social Finance, 2018).

New Zealand has paid particular attention to the transparency and integrity of the SIB procurement and evaluation process, engaging external legal council to undertake a *probity review* to verify the process was conducted in accordance with best practices with respect to tendering, conflict of interest, etc. (see as an example Ambler, 2016). The government also referred the work of the Ministry of Health, who has led the process supported by an interdepartmental team, to the Treasury, which commissioned an independent consultant to review the process and identify improvement opportunities, (The Treasury & Ministry of Health, 2016 & 2017). The consultant identified some challenges in the process, for example around the need for “commercial financial

expertise” (p. 7) and the need for greater senior civil service participation, that highlighted the significant demands of SIB engagement on government staff. According to government analysis, the report also demonstrated that “the requirement to undertake a market-led process has added time and complexity to the procurement process, as well as a loss in negotiation power for the Crown” (p. 8).

The New Zealand government is in the process of developing a second SIB aimed at reducing youth recidivism (The Treasury & Ministry of Health, 2017, p. 8). While the first SIB was based on only \$1.5NZM of investment, the government has established a fund of \$28.3NZM to fund outcome payments for future SIB activity, although this fund was also identified later as a source for administrative costs (The Treasury & Ministry of Health, 2017).

#### n) Sweden

As of 2017, Sweden has one active SIB focussed on school readiness for children in care, which was launched in 2016 (Social Finance, 2018). This SIB is relatively unique in that most of the activity is delivered directly by the public sector, with a private sector partner providing advisory services (Backström, 2016).

Two initial SIB-precursor pilot projects were run prior to this full SIB project being launched. One was implemented by the Center for Social Entrepreneurship Sweden (CSES) and funded by a public-sector innovation agency, Vinnova; the second was run by Fryshuset, a youth-serving social agency, with a grant from a lottery-supported innovation fund (Fryshuset, 2014; Mair, 2016; Solding, 2015). Social Impact Bonds in Sweden appear to have been motivated by interest from a number of stakeholders, with several organizations participating in a larger Nordic network on the topic organized by Mötesplats Social Innovation (MSI; Backström, 2015), a government-supported social

innovation institute based out of Malmö University. MSI and Vinnova in particular have been engaged in promoting SIBs in Sweden for several years (Lampty, 2014).

#### o) Switzerland

Switzerland launched its first and only SIB in 2015, a refugee employment project commissioned by the Canton of Bern, with over 70 funding and financing partners participating (Specking, 2015). The Swiss Federal government has not participated in any domestic SIBs to date but is an investor in the ICRC Humanitarian Impact Bond project being implemented in several African Countries, is partnering on a second DIB in Columbia (Social Finance, 2018), and is hosted an international conference on SIBs in 2018 (State Secretariat for Economic Affairs, 2018).

### III. SIBs Delivering results

Table 6 presents some summary data on the degree to which SIBs are achieving their targeted outcomes and repaying investors, with Appendix C providing detailed information by project and data sources. Table 6 data includes all projects launched prior to 2016, and captures all projects scheduled to be completed by January 2018. For completed and terminated projects, 44% have announced that investors have been repaid in full. For just under one-third of concluded projects, we were able to identify that that investors were at least partially repaid, for example for some years of the project and/or some outcome realizations, but were unable to identify whether full repayment had been made. Three completed projects, or 19%, only realized partial repayment due to targeted outcomes not being fully achieved. For two of these projects, two homelessness SIBs, we were unable to identify the percentage repaid; for the third, the first Portuguese SIB, only 25% of the investment was repaid. One project, the Riker's Island anti-recidivism project, has been the only project announced to date that has not met its targets with the outcome funder not making any payments to

investors. In this case, Goldman Sachs did have its investment secured by a partial loan guarantee from Bloomberg Philanthropies, which secured \$7.2USM of Goldman's \$9.6USM investment.

With respect to projects still in progress, 53% of projects are reported to be on track to meet their targets and be repaid, with one third of all projects in progress already having received some repayment. For the other 47% of projects, we were unable to identify any announced results to date.

Table 6		
<i>Investor Outcomes, for SIBs Launched Prior to 2016</i>		
<b><u>Completed and Terminated Projects (with results reported)</u></b>	<b><u># of Projects</u></b>	<b><u>%</u></b>
Investors repaid in full	7	44%
Investors at least partially repaid	5	31%
Investors only partially repaid	3	19%
Investor not repaid by outcome funder	1	6%
Subtotal, completed and terminated projects	16	100%
<b><u>All Other SIB Projects</u></b>		
Investors repaid for initial years' investment and on track for full repayment	12	33%
Investors on track for full repayment	7	19%
Investor repayment status unknown	17	47%
Subtotal, projects in progress	36	100%
<b>Total number of projects initiated prior to 2016</b>	52	

#### IV. Investor returns

Fully satisfying accounts of investor returns are challenging to assemble as one needs to rely, for the most part, on publicly reported measures, which are inconsistently reported and calculated. Very few projects have revealed actual rates of return paid out to investors for completed projects. We were able to identify three such cases, with annual realized rates of return of 12%, 24%, and a small foundation funded pilot SIB that did not repay a majority of the investment.<sup>23</sup> Appendix C presents project level data on projected investor returns for projects where at least one measure of return was

<sup>23</sup> The first two were early workforce development SIBs: the T&T Innovation SIB in Manchester UK which reported a 210% return on a £1.7M initial investment, and the Nottingham Futures SIB which paid out £2.5M on a £1.7M invested, both over 3.5 years (Social Finance, 2018). The negative return was for the €100,000 Junior Code Academy SIB in Lisbon, which only paid back 25% of the investment fronted by the Calouste Gulbenkian Foundation.

identified. Before reporting aggregating data based on average project returns, it should be noted that within projects, different investors may have different terms of repayment with different potential return rates and payment structures.<sup>24</sup> For example, non-profit or foundation investment often faces lower rates of return relative more conventional equity investor sources in the same project. More conventional investors may also hold preferred shares in the project to be repaid prior to other investors. The use of project average rates of return masks these discrepancies and dampens the variance of the data. Also, our data does not account for the fact that a SIB contracts may repay investors at various points throughout the contract as opposed to through a lump sum payment upon completion. Earlier repayment reduces the risk faced by investors; allows repaid funds to be recycled, reducing overall capital requirements; and increases the real value of payments to investors. This is partially accounted for when utilizing the internal rate of return (IRR) methodology to calculate rates of return, but this is only available for a small number of projects.

Data for most projects is available for total investment, length of project in months, and the total maximum outcomes payments available. This can be used to determine the maximum rate of return for the aggregate total investment per project on average, and reflects the maximum exposure of government over and above repayment of upfront investment amounts. This is presented in the sixth column of Appendix C.<sup>25</sup> Based on this measure, which was identified for 54 projects, there is a wide range of potential payoffs, ranging from -18.5% to 93.5%, where negative maximum rates reflect the cases where investors as a whole are subsidizing projects as opposed to receiving a return, with the unweighted average rate being 17.7%.

Column seven lists maximum investor returns, as reported in public sources. The set of SIBs for which we identified this data is smaller than the previous measure, with only 34 identified projects,

<sup>24</sup> To calculate average maximum and expected/target rates of return in the presence of multiple investor classes for a single project, the unweighted average of reported return rates was utilized. In the case of a reported range, the midpoint was utilized.

<sup>25</sup> The maximum aggregate per annum interest rate ( $i$ ) is the annualized return rate based on reported maximum outcomes payment available ( $P_{max}$ ) and total funds invested ( $I$ ), including in some cases grant funding. Letting  $t$  be the contract duration in months, it is calculated as  $i = \left(\frac{P_{max}}{I}\right)^{\frac{12}{t}} - 1$ .



including projects that reported total return on investment figures, which we convert to annualized return rates. Some of the reported maximum potential returns rates as reported in public sources may be higher than the maximum aggregate p. a. interest rate, as some SIBs have different investment classes, where subordinate investors, often foundations or charities, accept less advantageous terms and in effect subsidize the other investors. In addition, in a minority of cases grant funding may be included in total investment, having a similar effect. Measurement error and misreporting may also be a factor, as in some cases where there are multiple sources, reported information is not identical.<sup>26</sup> Reported maximum rates of per annum return in these 34 cases have a more restricted but still substantial range, from 1% to 30%, with an unweighted average return of 8.4%. Table 7 summarizes the data on maximum potential investor returns.

Table 7				
<i>Unweighted Average Investor Rates of Return</i>				
<u>Measure</u>	<u>Range - Min</u>	<u>Range - Max</u>	<u>Average</u>	<u>Sample Size</u>
Expected/Target return, reported	2.0	10.0	6.0	23
Maximum per annum return, reported	1.0	30.0	8.8	34
Maximum per annum aggregate interest rate*	-18.5	93.5	17.7	54

\* The maximum aggregate per annum interest rate ( $i$ ) is the annualized return rate based on reported maximum outcomes payment available ( $P_{max}$ ) and total funds invested ( $I$ ), including in some cases grant funding. Letting  $t$  be the contract duration in months, it is calculated as  $i = \left(\frac{P_{max}}{I}\right)^{\frac{12}{t}} - 1$ .

The challenge with the above analysis is that it does not account for the degree of risk inherent in individual SIB projects and the feasibility of achieving the maximum outcome payments. One possible explanation of large potential returns is the high degree of risk associated with SIB projects, and that SIB projects with higher risk of not meeting their targets are offering higher maximum returns. Table 8 presents data on unweighted average returns conditional on outcomes status, to

<sup>26</sup> For example, there are some small discrepancies between the Social Finance (2018) and Nonprofit Finance Fund (2017) with respect to the amount of upfront investment in US projects.

examine the hypothesis that riskier projects, proxied by those that have yet to repay investors, are more likely to have higher maximum returns. Using our maximum aggregate interest rate measure, the average maximum return rate for all SIB projects that have fully repaid investors or are on track to do so is significantly higher at 25.9%, than for the full set of SIBs, which is 17.7%, and for the remainder, which have an unweighted average maximum potential return rate of 10.9%.<sup>27</sup> This aggregate data does not provide evidence to support the hypothesis that higher maximum return rates have been associated with those SIB projects that are not paying back investors to date. In fact, it appears the opposite is true, with projects that are repaying investors having a higher rate of return on average than those with unknown repayment status and those that have not fully repaid investors. However, just looking at the small number of projects that have failed to fully repay investors, annual average maximum projected returns for the two projects that only paid partial returns was 32.7%, which is relatively high. Also, the one project that failed to repay any funding to investors, as noted, was backed by an 75% loan guarantee (Cohen, 2015), so the projected return on at-risk capital would have been much higher at 87.5%, compared to the reported 6.9% maximum rate of return.

<u>SIB Investor Repayment Status</u>	<u>Max aggregate p.a. interest rate<sup>28</sup></u>	<u>Max. p.a. return</u>	<u>Expected/Target return</u>	<u>#</u>
<b><u>Completed and Terminated SIB Projects (Publicly reported)</u></b>				
Investors repaid in full	28.8%	8.0%	7.5%	7
Investors at least partially repaid	33.3%	.	.	3
Investors only partially repaid	32.7%	.	2.0%	2
Investor not repaid by outcome funder	6.8%	6.9%	3.9%	1
<b><u>Other SIB projects</u></b>				
Investors repaid for initial years' investment and on track for full repayment	32.0%	10.9%	9.3%	1
	6.6%	14.3%	10.0%	7
Investors on track for full repayment	9.6%	7.5%	5.5%	1
Investor repayment status unknown				6

<sup>27</sup> This result is qualitatively similar for the reported p.a. and expected return rates, but the difference is much smaller, with the spread between the two groups around 4% points.

<sup>28</sup> The maximum aggregate per annum interest rate is annualized return rate based on reported maximum outcomes payment available and total funds invested, including in some cases grant funding. It is equal to = (Maximum Outcome Payment Amount / Upfront Investment)<sup>12/contract duration in months</sup>-1.

<b>All fully repaid SIBs, and those with potential for full repayment to investors</b>	<b>25.9%</b>	<b>11.6%</b>	<b>7.9%</b>
<b>All SIBs completed with zero or only partial repayment status, or unknown payment status</b>	<b>10.9%</b>	<b>7.4%</b>	<b>5.2%</b>
<b>Average</b>	<b>17.7%</b>	<b>8.8%</b>	<b>6.0%</b>

An alternative to maximum rates of return that ideally would more accurately reflect investor payback is the reported target or expected rates of return on investment, which we were able to identify for 22 projects and is reported in the eighth column of Appendix C. Expected/target rates of return range from 2% to 10% with an unweighted average of 6%. Looking again at projects initiated prior to 2016, SIB projects paying back investors have a higher expected rate of return than those without verified payment, again leaving us without a potential explanation for return differentials between projects.

This data highlights that many SIBs are offering quite high potential, i.e. maximum, rates of return, and when using a measure based on total return to investors collectively, average maximum return rates are substantial at 17.7% per annum. Returns are more modest when looking at projects for which reported maximum and expected/targeted return rates were identified. These are more in line with average stock market rates of return, but this raises questions regarding whether investors should be obtaining this level of returns, particularly given that investors benefit from the publicity and reputational effects of participation. These rates are also significantly higher than government's costs of borrowing, which have been at record low since the 2008-2009 financial crisis and the subsequent great recession. In one accepts this data as unbiased, such that projects that have publicly reported data are representative of the larger sample, our analysis suggests that there is very low rate of investors not meeting targets and not being repaid, and evidence that suggests the vast majority of investors have been or are on track to be repaid.<sup>29</sup> This raises additional questions

<sup>29</sup> One could speculate that stakeholders would be more likely to withhold results when the project did not meet targets for clients, however they may be equally tentative in releasing results in the case where investors generated very high rates of return.

regarding whether government is receiving value for money from the SIB model relative to more conventional procurement or direct pay by results models.

## V. Conclusion

The SIB model is still relatively new and in its early stages, and the scale of implementation relatively modest when compared to total social service spending, with 100 projects identified as launched at the end of 2017. Workforce Development is the leading sector in number of SIBs launched, while criminal justice has the highest investment, but a number of social policy areas have had multiple operational SIB projects. The UK, and later the US, were the early adopters of the model and continue to be leaders in number of projects, clients served, and funds invested.

While still a novel instrument with limited use, the number of SIBs is expanding rapidly and is well-positioned to continue its high rates of growth. In countries with a more established SIB market, this growth has been driven by an elaborate enabling field of supports, relying extensively on public sector subsidies, both financial and in-kind. Countries more recently engaging seriously with SIBs appear to be replicating this approach.

SIBs appear to be repaying investors quite consistently. SIBs face a large variation in maximum return rates, and we were unable to systematically link this to the risk level of projects, although the three of the four projects that have not repaid investors fully did have relatively high maximum rates of return for at-risk investment. This variation in return rates is a promising area for future research, likely requiring individual case studies with stakeholder cooperation to determine the underlying factors. While maximum potential overall rates of return to investors for SIB projects are relatively high in many cases, reported expected returns appear in line with stock market type returns, although expected returns are only reported in a minority of cases. It is unclear if these return rates are justified given the apparent high success rates of SIB projects meeting their repayment requirements. Evaluating this will require greater transparency and release of investor terms; to date

this has only taken place for a small number of projects. Precise reporting processes of actual returns paid to investors will also aid this process, which from our knowledge, has only occurred in a single case, the Newpin SBB (see: Loxley, 2017, pp. 8-9).

The status quo leaves much to be desired with respect to transparency on SIB projects, which was a significant problem in its predecessor, the P3 model, in the public works infrastructure field (Loxley, 2010). A standardized and transparent process for public disclosure around SIB projects would assist in determining whether public funds being paid out as outcomes payments are providing value-for-money relative to more conventional social service models, and whether the interest rates being paid out to investors, apparently well above the cost of conventional public borrowing, are justified.

# Part B: Efficiency-based Explanations of SIB Emergence

# Chapter 3: THE RATIONALE OF SIBS

## Introduction

SIBs have emerged in response to a number of challenges, including pervasive and ongoing social ills, lack of budgetary resources, and government administrative structures perceived as unresponsive and lethargic. In turn, SIBs claim to offer in response the promise of increased investment in cost-effective prevention programming, more successful social programs through improved collaboration, reduced risk for government, and a focus on results. Despite the apparent advantages of new resources and the promotion of results-based social investment, SIBs have not been without controversy. Questions have been raised regarding the ability of projected savings to offset the higher costs associated with the SIBs including the more complicated contract and administrative structure, the higher cost of private financing, and the net value added of the intermediary (Loxley, 2013; McKay, 2013; Stid, 2013, Whitfield, 2015). At their foundation, SIBs rest on a notion of the state as lethargic and incapable of innovation, relative to the private sector, and evidence on this is not conclusive. If SIBs are a costlier way of delivering interventions, and the total resources available for paying for these services is exogenously determined, then overall welfare may be reduced.

This chapter outlines the case made by proponents for SIBs as a superior vehicle for publicly funded social service delivery, and presents and categorizes some central propositions that have been made regarding the desirable attributes of SIBs that lead to improvements over alternative

delivery models. This is not a straightforward task, as proponents generally have not framed their arguments by explicitly comparing SIBs to alternative procurement or delivery methods but to a perceived dysfunctional state of affairs with respect to how government approaches social programs more generally. Unlike the more robust literature comparing program intervention models (see chapter 1), experimental studies of the impact of the procurement model utilized do not to date appear to have been undertaken.

In this chapter we focus on evaluating the claims of SIB proponents on their own terms and attempt to identify which element of the SIB model is responsible for the improvement over conventional practices. We categorize all the claims of proponents and trace them back to the two main distinguishing features of SIBs reviewed in Chapter 1, including private management and finance, and the payment by results criteria. We utilize three broad categories of proposed effects that SIBs lead to including: (1) a greater number of beneficial social programs being delivered; (2) an increase in the quality and effectiveness of individual programs delivered; and (3) improvements to the broader public social service system as a whole.

SIBs are claimed to permit more programs to proceed by leveraging new financial resources to deliver incremental social programs in the face of government budget constraints. The increase in quality and effectiveness are linked by proponents to the pay-by-results structure and the greater collaboration it necessitates across government, and the discipline and innovation of private sector participation. According to proponents, the broader public social service system benefits from a transfer of risk to the private sector, who are deemed more ready, willing and able to accept the risk, as well as from a change in culture and practices that emphasize evaluation and a focus on outcomes. We proceed by evaluating each of these claims in turn and the associated attributes of SIBs on which they are premised, but begin by outlining the case made for SIBs by proponents and their depiction of the status quo. The focus here is examining the logical consistency of the case presented by proponents and reviewing empirical support of these claims.



## SIB Proponent Narratives of the Status quo

Proponent SIB literature often bases the case for SIBs in relation to how government currently approaches social programs more generally. Essentially all proponents begin with a disparaging assessment of the status quo and more specifically how government is inept at addressing pressing social problems (Whitfield, 2015). Take Liebman's (2011) statement below:

Current approaches to government funding of social services create significant barriers to innovation. Funding streams tend to emphasize inputs rather than program objectives and are often overly prescriptive, requiring grantees to use a particular delivery model. In many cases, program outcomes are not rigorously assessed, allowing unsuccessful initiatives to persist for years.

Meanwhile, the public sector is slow to adopt new program models, even those proven to be highly effective. There is no systematic process through which philanthropically funded interventions with demonstrated success receive the government funding necessary to expand. Investments in preventive services can be particularly difficult to finance (p. 1).

Liebman and Sellman (2013) present a similar statement, adding that "tight budgets cause us to under-invest in prevention... [and] threatens to stifle innovation.... we are simply not making rapid enough progress in addressing social problems" (p. 6). Dear et al. (2016, p. 12) comparably criticize the status quo, describing a context where:

Government struggled to support or encourage innovation in the social arena, contracts between government and delivery organizations stifled creativity and adaptation, and the social sector had no effective way of being rewarded for successful outcomes. These were and still are huge problems... services for some of the most vulnerable in society are often bureaucratic, one size fits all solutions... innovative, holistic services are occasional pinpoints of light ...we are providing an array of services to some of the most vulnerable in society without actually knowing if they work and without gathering the knowledge to improve them or know whether they should be provided in the future (p. 12).

Deloitte (2014, p. 2) while using gentler language, emphasizes the same points, including that “measurable outcomes can be elusive”, the “limited incentive for innovation”, and that “collaboration from a number of groups and perspectives... are often limited in the established structures of our public institutions” (p. 2). Gustafsson-Wright et al. (2015) note “the inability of governments to equitably deliver high-quality services in the education and health sectors...aris[ing] from lack of resources, ineffective use of such resources, or both” (p. 1), with “undue focus on more expensive curative or crisis-driven interventions, resources not reaching frontline service providers, weak incentives” (p. 2). They also claim that “government systems... can be bureaucratic and distant from reality” with “insufficient attention to performance and to measuring” and “political and institutional constraints” such as “election cycles, budget silos, and complex or rigid government appropriation systems” (p. 2). The Harvard Kennedy School (2017) points to a “lack of performance assessment, under-investment in prevention, and inability to collaborate effectively with service providers around improving system”. Mulgan et al. (2011) are the exception in that they are less critical of government, focusing more on budgetary challenges in the post-2008 financial crisis environment, “incentives [that] are poorly aligned”, and that it is “difficult to secure funding for initiatives that set out to prevent undesirable outcomes” (p. 15).

Liebman and Feller (2014) formally model the claimed government failure through four channels: First, governments undervalue innovation in social benefits relative to its social value since they only consider the benefit the innovation provides within its jurisdiction. Secondly, since “governments rarely conduct rigorous evaluations” (p. 8), ineffective programs persist, so experimentation by introducing new programs leads to growing costs as pilot projects become permanent, regardless of outcomes. Thirdly, they discount future benefits of social innovation too highly due to political considerations and “siloes decision-making” (p. 8). Finally, governments misallocate resources internally, over investing in direct delivery of services and under investing in management, administration, and evaluation.

## Proponent Claims of the Advantages of SIB

Proponents then highlight how components and advantages of the SIB model that help overcome these barriers. For example, Dear et al. (2016) highlights “the values of partnership and collaboration, flexibility and responsiveness, and a focus on data, outcomes, and measurement” (p. 7), later also noting “the payment mechanism, and the delivery oversight (p. 53). Liebman (2011) points to “performance-based payments and market discipline” (p. 1), “private financing to overcome existing barriers to performance-based pay”, and “private investors['] ... quality control”, both at the project selection phase and during the contract (p. 2), leading to the “rigorous ongoing evaluation of program impacts into program operations, accelerating the rate of learning about which approaches work and which do not” and their “adoption”(p. 3). Liebman and Feller (2014) also highlight how grant support bridges the gap between the returns to the government undertaking the SIB and the broader social return of the innovation which can then be replicated elsewhere (p. 18).

Gustafsson-Wright et al. (2015) come the closest to a systematic inventory of the claims of SIBs, identifying 10 distinct claimed advantages of SIBs including the ability to “crowd-in private funding, prioritize prevention, reduce risk for government, shift focus to outcomes, achieve scale, foster innovation in delivery, drive performance management, stimulate collaboration, build a culture of monitoring and evaluation, and sustain impact (pp. 36-47). We use three categories to classify these claims below including SIB’s ability to deliver incremental social services, higher quality social services, and have positive system level effects on the operation of government.

### I. Claim 1: SIBs Allow More Social Programs to be Delivered

One claim made by SIB proponents is that SIBs allow new additional cost-effective preventative social interventions to proceed (Pauly & Swanson, 2017). Rothschild (2013) speaks to their “incremental investment in high performing social enterprises” (p. 106); while Mulgan et al. (2011) state that SIBs are “unlocking new funding” for important and valuable social initiatives that

currently are not going forward due to lack of funding (p. 15). A related form of this argument is the claim that SIBs facilitate the scaling up of successful interventions (see: Burand, 2012; Gustafsson-Wright et al., 2015, pp. 41-42). Dear et al. (2016) for example note that SIB “programs have mainly been additive, not a replacement for existing services, or have changed the contracting framework of services which were already delivered by outside service providers” (p. 44).<sup>1</sup> The degree to which these new programs are incremental as opposed to a change in delivery model for existing programs is an important consideration, one that has not been systematically determined to date.

#### a) New Private Funding and Financing

For new prevention programs to be incremental requires that new money materialize or be advanced to fund these initiatives. SIBs are clearly designed to attract new private capital into supporting social service delivery. Gustafsson-Wright et al. (2015) conclude that SIBs are attracting capital from “both traditional [philanthropic / foundation] investors and new investors” but that it is not clear if these funds “represent a shift in assets under management from one sector to another or if they equate to some additionality” (p. 38).<sup>2</sup> Here it is also important to keep in mind the distinction between financing and funding sources discussed in Chapter 1. As Gustafsson et al. (2015) note “if outcomes are achieved, outcome funders (governments) will have to pay for the services” (p. 37); In this case new funding is not being generated by private investors, only new financing. As Gardiner and Gustafsson-Wright (2015) put it: “investors are solving a liquidity problem for government by providing upfront capital and not actually providing new money”. In fact, the government may end up paying more than they would have under alternative delivery models (Fraser, Tan, Lagarde &

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<sup>1</sup> A related issue is the degree to which SIBs programs are reliant on existing social infrastructure and services, and to what extent it is the SIB or the underlying service that is providing the benefit. As least two SIB projects, the Partnering for Family Success Program in Ohio, and the Sweet Dreams SIB in Saskatchewan, rely on the utilization of public or social housing not being funded under the SIB. See Loxley (2017, p. 20) and Pennell (2014) This raises questions regarding the impact of access to housing itself relative to the broader SIB, and the degree to which a limited public or social housing stock is simply being reallocated to families in the SIB projects away from others.

<sup>2</sup> See also Fraser, Tan, Lagarde & Mays (2018, p. 19).

Mays, 2018, p.16), potentially reducing the real quantity of preventive social services procured if government resources for this purpose are fixed.

There are however scenarios that have been realized in practice where the private sector participants end up being funders. First, if an SIB fails to meet its targets, at-risk capital invested ends up funding the incremental social service. The degree to which this is realized as a new source of funding depends on the availability of socially motivated investors with a high loss tolerance, or the realization of unexpectedly high systematic failure rates. Other than the high-profile failure of two pilot SIBs in the US and Portugal, other SIB projects appear to be repaying investors, with a large majority of projects reporting results publicly having met or on track to appear to be meeting their benchmarks (see Chapter 2).

Secondly, many SIBs are not fully based on risk capital, with projects also being funded by non-outcome-based grants or donations. SIBs may attract new grant funding to the total philanthropic donation pool because of their structural characteristics, for example the strong emphasis on outcomes or the claim of promotion of new innovative approaches. In the stylized SIB model however, the government funds successful outcomes, not the private sector. While there are some cases where the new funding, as opposed to financing, may be generated through private sources, these cases appear to be exceptional or due to reallocation of traditional funding sources.<sup>3</sup>

## b) New Public Funding

As noted above, SIBs can generate incremental investment by “solving a liquidity problem for government” (Gardiner & Gustafsson-Wright, 2015). State leaders face at least two budget constraints. An inter-temporal budget constraint must be met such that the expected real present value of government expenditures minus current debt cannot exceed the expected present value of

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<sup>3</sup> This assessment is based on the author’s review of the funding sources and participants assembled in a database and discussed in more detail in Chapter 5.

real tax revenues (Romer, 2006, p. 560). This can be considered the 'real' budget constraint of government, and is necessarily based on predictions of government behavior into the future.<sup>4</sup> However, standard accounting conventions lead to this budget constraint not being publicly reported. What is reported are measures of current levels of government spending, revenue and debt.

These publicly reported set of budgetary indicators produce a second set of accounting-based indicators, including the standard reported notions of budgetary balance or deficits or surplus. The effect of specific policy actions on these measures and reported budget balance, such as asset sales and the assumption of unfunded liabilities, are not necessarily indicative of their effect on the real government budget constraint: for example, asset sales reduce the deficit and have an ambiguous effect on the budget constraint, while the assumption of unfunded liabilities impacts future expenditures with no effect on standard measures of the debt and deficit (Romer, 2006, pp. 562-563). Based on these reported indicators, governments may choose to self-impose, through legislation or policy, budget constraints at the aggregate level and/or at department budget levels based in some fashion on these indicators. One particularly pervasive expectation is that governments should balance their overall budgets over some time horizon, giving rise to one of the most common types of legislation in this area, balanced-budget legislation, which requires the government to balance its budget each year or over a longer time period.

Unless an SIB provides savings in excess of its cost, an SIB will not loosen a government's real budget constraint, but SIBs may permit governments to temporarily relax self-imposed institutional budget constraints through the PbR structure, which can defer cost of payment in some cases to the end of the SIB contract.<sup>5</sup> The contingency-based payment structure of SIBs has been interpreted in

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<sup>4</sup> The mechanism for enforcement of this constraint is the government issued securities market, in which debt rating agencies play a central role. As governments increase their debt relative their deemed capacity to repay lenders, they will increasingly be forced to pay a higher rate of interest to issue new bonds. As long as the economy is growing, and that growth rate is greater than the interest rate on debt, governments can continue to borrow and face a stable or declining debt to GDP ratio, and avoid an endogenous debt crisis. See Taylor (2010, pp. 242-246).

<sup>5</sup> The logic here parallels that of public asset privatization for the purpose of generating revenues, as summarized by Vickers and Yarrow (1991, pp. 118-119), who highlight the inferiority of this strategy relative to raising funds through the bond market for developed countries with low risk of default.

such a way that it removes the requirement for government to finance the project upfront, as would be required under more traditional procurement models, generating new resources for social programs that without the model may otherwise be unavailable. This can make SIBs attractive to governments struggling with deficit management due, for example, to ongoing consequences of the 2008 financial crisis, but who are looking to increase investment social programs.

Social Finance (2011), a non-profit organization which specializes in the promotion and creation of SIBs, advises that the business activity of the SIB delivery agency need not be reflected in public accounts if the agency is determined to be separate from government (pp. 23-24, 34-36). Additionally, they note that government obligations to pay the SIB will likely be accounted for as an executory contract, provision or contingent liability, all of which are accounted for at time of payment, and therefore costs do not appear as a long-term liability in government accounts, unless payments are fixed or fully guaranteed regardless of project outcomes (pp. 37-39).<sup>6</sup> If auditors agree, this allows governments to defer accounting for payments for social services delivered under an SIB or other PbR contract that otherwise would have been counted as a current expenditure. This could lead to SIBs supporting incremental social program delivery in the current year, assuming that government maintains existing expenditure, without affecting the budget balance.

This accounting flexibility however may be offset by investor demands for greater government accountability with respect to its commitment to pay under an SIB. Generally future governments are not bound by the spending commitments of previous legislatures that span beyond the current fiscal year, creating uncertainties for investors regarding the reliability of success payments, leading to legislative change to facilitate future payments (Liebman & Sellman, 2013, p. 25). Some of these legislative approaches compromise the noted budgetary flexibility and set aside current funds for future outcome payments. For example, the State of Utah's School Readiness Initiative Act of 2014

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<sup>6</sup> Whitfield (2015) also highlights how the off-balance sheet nature of SIBs create an accounting-based advantage for SIBs, generating incentive to structure activity through these instrument potentially higher costs and other negative impacts.

established the School Readiness Restricted Account to fund PfS initiatives. A similar approach is utilized in California with its Recidivism Reduction Fund (Board of State and Community Corrections Act, 2013-2014).

Other legislative approaches may explicitly fund initiatives completely from targeted social service savings such that expenditures need to be reduced in another area, leaving the net impact on overall incremental spending unchanged. Idaho, for example, in its Pay for Success Contracting Act of 2015, requires that SIBs be fully funded by explicitly identified savings and that these savings be set aside in a designated account, to be available to fund payments required under the SIB contract. Other states that have established PfS funds in legislation include Oklahoma, Maryland, Colorado, Massachusetts, Texas as well as the District of Columbia (Hathaway, 2016). While losing the accounting flexibility, these legislative funding models, in addition to reassuring investors, also create a funding source to fund SIBs that otherwise would require an incremental allocation in the year or years in which targeted outcomes are achieved and payments are due. Overall, the legislated funds provide for a more transparent process and reliable funding source. The degree to which total preventative funding is impacted will rely on if these funds are new incremental funds or whether they were previously budgeted for non-SIB prevention-focused programming.

### Savings as New Funding Source?

As discussed in Chapter 1, SIBs have the potential to be self-funding. SIB proponents have argued that by only paying in the presence of successfully met outcomes, and limiting contracts to outcomes with net fiscal savings, the government does not need incremental funds to support SIBs as they pay for themselves through savings (Fraser, Tan, Lagarde & Mays, 2018, p. 10). For this self-financing to be operationalized, governments must commit to identifying and allocating the operating funds saved to an accrual account to recover the cost of the SIB, as is being required by some of the SIB legislative frameworks noted above. It is this new financing structure that is at the center of SIBs as a financial innovation and is arguably its most innovative attribute.



Self-funded SIBs are a financial innovation in that they create a formal structure to borrow against these projected social savings and may allow more of these unfunded preventative projects to proceed. Governments can therefore notionally finance the contract from the present value of costs they would otherwise incur if the intervention had not taken place, presuming the savings are sufficient to fully offset the cost, apparently creating a new funding source to pay for social programs that did not previously exist.

It important to note that it is not the SIB which is generating the new funding source, it is the preventative social service itself. If the social service outcome success probability is independent of the procurement model, governments could alternatively issue traditional government bonds to deficit finance proven social investments that generate present value savings greater or equal to their costs, at government borrowing rates. This would leave the government as the recipient of the benefits as opposed to investors in the SIB model, and would preclude the expenses associated with any additional administrative and transaction costs associated with the SIB structure. This leads to the critique that government should be financing these services directly given their lower cost of borrowing (Mulgan et al., 2011, p. 17). Whether funded by an SIB or not, government benefits from the projected savings used to validate a self-funding SIB. The question then should not be 'are SIBs able to generate savings in excess of their costs?', but 'do SIBs deliver the highest net benefit when compared to other service delivery models'. This is complicated by the fact that the procurement model may impact the quality of the service and/or likelihood of success. We explore this issue more formally in Chapter 4 when drawing upon the insights from the theory and experience with PPP infrastructure projects.

### c) Assessment of Claim 1

The evidence on SIBs generating new funding for prevention initiatives is inconclusive. While private capital is coming forward to finance SIB projects, if the SIBs are successful the government must pay back this investment plus a return (Dear et al., 2016, p. 20), in addition to any incremental

administrative or transaction costs associated with the model (Fraser, Tan, Lagarde & Mays, 2018, p. 16), and it is unclear at this point if these funds are simply being reallocated from other philanthropic activities (Gustafsson-Wright et al., 2015, pp. 37-38). There does not appear to date to be significant failure of SIBs resulting in new program implementation that government is not paying for, despite insinuations from some proponents that failure should be expected and part of a government's SIB strategy (see for example: Liebman & Sellman, 2013, p. 29). The direct savings due to funding only successful projects therefore are likely minimal. SIBs may be attracting more traditional philanthropic support such as grants or investment guarantees, due to the emphasis on outcomes and prevention, which may be attractive to donors. This may also result in a shift of donations as opposed to incremental new contributions, but to date this has not been verified.

Several features of the SIB model together however create the potential to allow more prevention focused social programs to proceed, that would not have otherwise, through its financing ability. The combination of utilizing private off-books financing that keeps the expense temporarily outside of public accounts, a full outcomes-based payment structure, and limiting projects to those that generate cashable fiscal savings in excess of the SIB payout, means that government can use SIBs to skirt self-imposed budget constraints and fund more of these programs. But many governments are setting aside current funds for future SIB payments, creating additional pressure on budgets as opposed to generating new funds (McKay, 2013, p. 13). Alternatively, if not funded in real time, diligence is required in capturing fiscal savings for these eventual costs, otherwise government will be faced with a large unbudgeted lump sum cost if the contract is successfully executed by the private partners.

The idea that SIBs can pay for themselves is the most promising source of new funding, but this funding is generated by the social service itself and is only required because government chose to restrict traditional funding for these activities despite the strong value for money case. This becomes particularly transparent in the case where governments set up upfront funding sources for SIBs

programs. SIB proponents have also moved away from claims of the ability to self-fund (see Chapter 1). More fundamentally, the potential value of SIBs then rests not on their ability to generate new funding, but their ability to promote higher quality social programs that generate these type of social and fiscal benefits, either directly or by generating systematic changes that are more likely to produce such social programs.

## II. Claim 2: Better programs: Higher quality and greater effectiveness

The second claim made by SIB proponents is that they lead to higher quality outcomes or deliver better results compared to social programs procured through conventional means. There are several mechanisms that produce this proclaimed improvement, including better management and project selection leading to more effective service providers, the promotion of innovation, and greater collaboration, which are leveraged through the introduction of private finance and the PbR structure. The quality enhancement and improved effectiveness potential of an SIB is driven by privatizing management of the project and the introduction of high-powered financial incentives payment structure, where the term privatization encompasses any transference of service delivery, including management responsibility, from the public sector to the private sector, though the transfer of assets and/or contracting out.<sup>7</sup>

### Better Management and Project Selection

Private finance is claimed by proponents to bring benefits to SIB projects beyond the direct financial support, including improved project selection, project management, and transference of business sector skills and practices to the social service delivery sector. In general, SIBs are claimed

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<sup>7</sup> Some authors have defined privatization more narrowly. Domberger and Jensen (1997) for example distinguish between contracting out and privatization, where the latter involves specifically the transfer of assets from the public to the private ownership. Others have used broader definitions. For example, Starr (2014, p. 21) settles on a definition of “any shift from public to private of the *production* of goods and services”, while noting an even more inclusive utilized conception would include “the shift of any activities or functions from the state to the private sector” which would include activities such deregulation. Vickers and Yarrow (1990, p. 112) clearly categorize the contracting out of services that were previously undertaken by the public sector as a type of privatization, as does Hodge (2000, p. 14). We follow these latter authors.

to “introduce the discipline of private capital” (Dear et al., 2016, p. 51). At the project selection phase, private finance is claimed to lead to the selection of better programs. According to Liebman (2011), “private investors...perform an important form of quality control... service providers must convince the private investors that their program model and management team are likely to achieve the performance targets” (p. 2). Once the project has been selected, the private investors are also claimed to bring more effective project management skills to the program, or as Dear et al. (2016) put it, SIBs “harness the discipline of the private sector and add rigor” through their “active performance monitoring and management” (p. 80).

Liebman (2011) captures this concisely and links it back to the PbR structure of the SIB: “the investors and bond-issuing organization... have strong incentives to rigorously monitor and improve program performance; if performance targets are missed, they will lose the money they invested” (p. 2). The supposed rigor of private sector management leads to service providers under an SIB to implement the systems changes to track outcomes as opposed to outputs as required by the PbR model, developing and enhancing their capacity in this area (Fraser, Tan, Lagarde & Mays, 2018, pp. 9-10). This emphasis on data collection creates the basis for other changes to improve operations efficiency.

Stakeholders point to how SIBs demand adaptation to a more rigorous, iterative, and flexible management process, which Dear et al. (2016) refer to as “a new way of working which stretches the service provider beyond its normal field of view” (p. 32). This requires that in general, service providers “accelerate their learning and review cycles to respond to incoming data and ensure the project is achieving the desired outcomes” (p. 32) and is an iterative process that may draw upon all institutional participants in an SIB. Dear et al. (2016, p. 31) emphasize that it is these changes at the service delivery level that are the central channel through which SIBs lead to better outcomes. SIBs also provide greater stability for service providers given their multi-year nature, reducing uncertainty around funding and allowing service providers to focus on meeting well-defined

evidence-based social service objectives (Mulgan et al., 2011, p. 16). In general, the better management and project selection case argument highlights how SIBs can lead to a more efficient combination of inputs, taking existing social service production technology as given, pushing providers towards their production possibilities frontier.

## Innovation

The focus on outcomes and collaboration also lead to the claim by proponents that SIBs will generate innovation in social service delivery (Fraser, Tan, Lagarde & Mays, 2018, p. 10), or an improvement in the production technology used in social service production. Social Finance UK Founder Toby Eccles has called SIBs as “a highly effective catalyst and momentum builder for innovation.... often...provid[ing] politicians with a route to encouraging public servants into trying something new” (Dear et al., 2016, p. 17). Liebman and Sellman (2013) claim they are “designed to promote innovation in addressing social problems” (p. 29). Some proponents however have argued that SIBs should not be expected to generate innovation and should focus on the right combination of successful interventions (Callanan & Law, 2013, p. 79; Morse, 2015, p. 21). This fits well with the finding of Lipsey & Cullen (2007) that the issue in social service delivery, in areas such as anti-recidivism and healthcare, isn't finding what works, it's that systems don't implement what works (p. 315).

## Collaboration and Alignment of Incentives

SIBs, by design, generate an intentional realignment of incentives to produce new forms of collaboration within government and between public and private sectors. Mulgan et al, (2011) highlight how SIBs are “promoting evidence based action” and “correcting poor incentives”, noting that “in many fields of public policy, incentives are poorly aligned, with those who have the ability to improve social outcomes lacking the incentive to act” (p. 15). Through the construction of the SIB contract, the emphasis on measurement, and the foundation of the PbR contract on preventative savings, SIBs then are claimed to foster better collaboration across government departments to

better align incentives. Toby Eccles, the founder of Social Finance UK, emphasizes the importance of central government initiative and in particular central government funding support to drive this process (Dear et al., 2016 p. 17). This increased collaboration generated by PfS structure extends beyond government to include all SIB institutional participants and is claimed to be “catalyzing systems reengineering in a way that rarely occurs with standard public sector management practices” (Harvard Kennedy School, 2017).

There are two distinct arguments or stages through which better incentives and collaboration operate to generate superior outcomes. The first is, by design, an SIB drives some central government actor who is ‘above the fray’ of supposed siloed, interdepartmental bureaucratic politics, to calculate the benefits and cost reductions of an intervention. By doing so it generates an SIB contract that internalizes the externalities that previously led inward-looking government departments to neglect the impact of their action or inaction on other departments or society more broadly. This creates the appropriate ‘demand’ by government for the ‘right’ type of action or activity. The ‘supply’ of service to meet the constructed demand is through the PbR contract structure, which in turn leverages the discipline and innovative capacity of the private sector management. Because the government is paying only for outcomes, they relinquish the ability to set restrictions on who is part of the service team and how they do their work, generating a flexibility to include new actors, in particular private finance, and structure service delivery how they see best accomplishes the targets set out. This facilitates the second stage of collaboration, now between the private participants in the SIB, specifically the service providers, including the intermediary and any technical assistance providers, as well as the financiers.

### The (Lack of) Direct Evidence Regarding SIB Effectiveness

As discussed in Chapter 2, the growth of SIBs has proceeded based on a foundation of support and promotion by government, specialized proponent organizations, and other stakeholders. This growth has been supported by the evidence base of preventative interventions and the existence of

a client base who can benefit from these services, not the demonstrated superiority of the SIB model itself. The limited status of the evidence base has been acknowledged by some proponents. For example, Dear et al. (2016) note that “projects have mainly reported interim, not final, results and the extent to which they improve outcomes has varied” (p. 26). Academic assessments concur, with Fraser, Tan & Lagarde and Mays (2018) in their extensive literature review of both academic and grey literature, referring to a “paucity of evidence about SIBs [with] most of the material identified...best described as commentary” (p. 14).<sup>8</sup>

This limited evidence base has not stopped proponents from claiming that the model is delivering results. Dear et al. (2016) for example claim that the SIBs to date have a “promising, if early, record of success” and base this claim on the fact that “of 22 projects that have shared performance data as of June 2016, 21 indicate positive outcomes for some participants” (p. 26). In general, they claim that “the most critical measure of success in a Social Impact Bond is social impact: did the project lead to better outcomes for participants? Did the intervention improve the lives of people in need?” (p. 23). Recently, the first ever SIB contract concluded and was deemed a success for exceeding targets and fully repaying investors plus a 3% annual return (Owen, 2017).

This assessment criteria for success is problematic. As discussed in Chapter 1, great emphasis is placed in SIBs on distinguishing the “results—the reported outcomes of a program—and attributable impact—the outcomes that can be specifically tied to the social intervention” often with sophisticated statistical techniques (Dear et al., 2016, p. 26). This methodological rigor lends credence to the assertion that the results and the success being generated are genuine and due to the SIB intervention. This definition of success however, from a value for money perspective, is problematic when seeking to determine whether the SIB model itself should be considered a success.

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<sup>8</sup> See also Fraser, Tan, and Kruihof, 2018. There are efforts to systematically document and evaluate experience and the SIB experience. For example, Commissioning for Better Outcomes fund in the UK is support the evaluation of 10 SIB projects, with three reports each, conducted at the launch, half-way point, and completion of the SIB projects. At the time of writing, only three first-stage reports had been conducted to date (Big Lottery Fund, 2017).

The idea that the service being delivered should positively impact participants presents a fairly low standard of ‘success’, and amounts to, in a cost-benefit framework, looking only at the benefits and not the costs. From a public policy perspective, determining the validity of the SIB model should involve a comparative analysis between the SIB model and other feasible service delivery models such as public delivery, conventional procurement, or conventional outcome-based payment schemes. Neglecting to make this comparison and only focusing on participant outcomes is equivalent to looking only at ‘results’ without identifying ‘attributable impact’, an error that SIB proponents, ironically, are highly aware of when it comes to evaluating the impact of a specific intervention but appear to completely neglect when analyzing the delivery model itself. As Fraser, Tan, Lagarde and Mays (2018) puts it: “To date, across all active SIBs, there has been very little rigorous counterfactual comparison of SIBs versus alternative methods of finance to deliver the same service to the same type of users, and thus a lack of evidence of costs and benefits compared with the alternative approach to procurement” (p. 13).<sup>9</sup> In later chapters we examine in more detail how this can be accomplished and what assessment mechanisms and frameworks exist to undertake this type of analysis, but here we review the limited direct assessments of the track record of SIBs on delivering higher quality programming as well as the evidence on the effectiveness of privatization and PbR contracting, which have a more robust history and evidence base.

#### a) Direct Assessments of SIBs Leading to Higher Quality

Gustafsson-Wright et al. (2015) provide one the few systematic reviews of SIBs conducted to date aiming to assess whether SIBs have achieved their goals as articulated by their proponents. Their study however does not directly address the question of whether SIBs are leading to improved social programs, but assess program characteristics that are presumed to lead to greater effectiveness. Some of their criteria assess whether SIB projects are staying true to the model and in a sense, are true by their definition of SIBs. These include verifying that SIBs are: attracting private capital,

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<sup>9</sup> See also Carter et al., 2018, Fraser, Tan, and Kruithof, (2018), and Floyd (2017, p. 12).



supporting programs focused on prevention, transferring risk from government to funders, prioritizing outcomes, and generating collaboration between public and private stakeholders. Their criteria that have the most intuitive and plausible connection to improving quality include: the promotion of innovation, increased performance management capacity, collaboration across government stakeholders, a “culture of monitoring and evaluation” in government and service agencies, and the ability to “sustain impact” overtime (p. 45-46). They find that innovation has been marginal and limited in the most part to new combinations of existing programs, and that performance management has been enhanced but there is no evidence that service providers have made program adjustments in response. They did find examples of collaboration within government and early signs of a more rigorous monitoring mentality and longer-term impacts, but it is not clear that these findings are generalizable.

Other studies have confirmed the intensive performance management reforms that take place in SIB projects. An early review of 10 SIBs commissioned by the UK Department of Pensions found a “continuous process of monitoring and performance management” with many service providers “not anticipat[ing] the way in which the funding model would drive delivery” (Insite Research and Consulting 2014, p. 10). Edmiston and Nicholls (2018) conduct a study of four SIBs projects in the United Kingdom. They found limited evidence that the SIBs promoted innovation relative to previous PbR schemes (pp. 66-67) and that “some third sector stakeholders felt that the degree of micro-management built into the SIB was actually reducing their flexibility ..., that the resources and time that went into these additional forms of performance management and measurement could be better spent on front-line services” (p. 64). Two of the SIBs were not “able to produce improved social outcomes relative to previous and other existing service interventions” (p. 68); one had qualitative evidence to support superior performance, and another showed signs of improved outcomes but the baseline comparison was not current with standard intervention practice. They conclude that “the prospective benefits of service innovation appeared to originate more from the novelty, size and

experimental nature of the PbR contract.... If anything, the presence of private social investment appeared to stifle the flexibility and autonomy of service providers to innovate and deliver services” (p. 73). They also highlight the problematic nature of the counterfactuals used, generally being administrative data, as opposed to control groups (p. 69).

Based on data compiled by the Nonprofit Finance Fund (2017), 11 out of the 20 SIBs launched in the United States to date were based on interventions that have been evaluated for effectiveness with the specific population being targeted, and another seven had been evaluated but not in the specific context being applied in the SIB, such that the combination of interventions been tested separately as opposed to in combination, or the intervention had been tested with a slightly different population. Furthermore, in 15 of the 20 SIBs, service providers providing the intervention had delivered these interventions with the targeted population prior to the SIB project, in an additional three cases only some members of the service provider consortia had delivered the programming previously. Therefore 90 percent of US SIBs have been using programming with a strong evidence base of effectiveness, with 90 percent of US SIBs including service providers who had previously delivered the same service intervention.

## b) Empirical Evidence of Privatization Leading to Better Management and Innovation

### *Privatization Evidence*

Arguments for private sector efficiency and privatization can be traced back to the significance of the profit motive and the competitive pressures that private firms face, and ignore at the risk of going out of business or being taken over. Specifically, private firms are subject to shareholders demanding maximum lifetime returns on their investment, the risk of corporate takeover if shares be undervalued due to inefficient management, and the threat of bankruptcy.<sup>10</sup> This is relative to a

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<sup>10</sup> For a summary and critique, see Vickers and Yarrow (1995, pp. 8-44).

monopoly public provider who, in the Public Choice paradigm, will over supply services to maximize the potential self-serving opportunities for management (Bel, Fageda, & Warner, 2010, p. 555; Letza, Smallman, & Sun, 2004, p. 165) and will fail to innovate due to lack of competitive pressure and information that markets provide (Petersen, Hjelmar & Vrangbæk, 2017, p. 4). The property rights literature emphasizes how public-sector employees have little incentive to undertake quality enhancing investments to stimulate productivity due to a lack of ownership over productive assets and the ability of managers to expropriate any gains.

However, the a priori association of privatization with competition is lacking, as depending on the market characteristics, the existence of multiple public-sector organizations competing to provide a service is conceptually just as possible as that of a private monopolist (Hart, Shleifer & Vishny, 1997, p. 1129; Vickers & Yarrow, 1995, p. 45). Even if competition is present, particularly in social services, there is no guarantee that this will drive efficiency enhancements and innovation (Finn, 2008, p. 43).

The assertion that shareholders will hold a firm to account is also tenuous. Chang (2003) for example notes that private firms face the “problem of ‘shareholder collective action’” (pp. 209-210) such that unless ownership is consolidated, given the diffusion of shares, few individual shareholders will be motivated to provide a high level of oversight due to the free-rider problem associated with better firm outcomes.<sup>11</sup> In the public-sector management case, there will likely be a single or small number of public-sector entities responsible for outcomes, held accountable by “institutionalized mechanisms of collective action” unavailable to private shareholders (p. 210). He also notes that the proposed rationale for privatization generally reduces to principal-agent problems associated with public governance that idealize the operation of private sector firms while ignoring principal-agent problems within the corporate governance structure of publicly traded corporations. Specifically, privatization often involves the privatized service being adopted as a subsidiary of an existing

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<sup>11</sup> See also Sappington and Stiglitz (1987) and Olsen (1965).

corporate structure, replicating the principal-agent structure and associated supervision and information asymmetries. Stiglitz (2008) makes a similar case, noting that once the neoclassical assumption of perfectly functioning markets and in particular the assumption of perfect information is relaxed, “the theoretical case for privatization is weak or non-existent” (p. xii).

Based on this theoretical ambiguity, one must turn to the empirical evidence (Vickers & Yarrow, 1988, p. 39). Results with respect to efficiency from empirical studies of privatization are mixed, with evidence on the wave of privatization that took place in the 1980s and 1990s often pointing to lower costs but also lower quality service (Hart, Shleifer & Vishny, 1997, p. 1127), with costs savings being the primary motivation driving privatization efforts (Auger, 1999, p. 440; Bel, & Fageda, 2007).<sup>12</sup>

Estimates of cost reductions vary widely and have evolved overtime, with some early estimates concluding, with caveats, that privatization leads to greater efficiency. For example, historical estimates at the US state level estimated savings in the 1990s were reported to be as high 20% for a small percentage, but with evidence indicating that for a large majority the savings had been minimal, in the range of less than five percent, with significant variation depending on service type, with “administrative services, mental health and retardation services, and transportation initiatives” generating the highest savings (Auger, 1999, p. 441). Vickers and Yarrow, (1988, pp. 39-43), reviewed studies of railroads, electrical utilities, water distribution and waste collection, airlines, water transportation, steel and energy resource appliance production. While noting several reservations with existing studies, they concluded that “where competition is effective, the available evidence suggests that private enterprise is generally to be preferred on both internal efficiency grounds and subject to the qualification that other substantive market failures are absent, social welfare grounds” (p. 43). Three years later Vickers & Yarrow (1991, p. 117-118) come to similar

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<sup>12</sup> While costs may be the primary factor noted, the full set of motivations for privatization is large. Vickers and Yarrow (1988) for example note the objective of the expansive privatization program that took place under Prime Minister Margaret Thatcher in the 1980s included: “(i) improving efficiency; (ii) reducing the public sector borrowing requirement (PSBR); (iii) reducing government involvement in enterprise decision making; (iv) easing problems of public sector pay determination (v) widening share ownership; (vi) encouraging employee share ownership; (vii) gaining political advantage” (p. 157). Hodge (2000, pp. 18-24) has a similar extensive list, but also has economic efficiency as the priority. We place some non-efficiency explanations of privatization at the centre of the analysis in Chapter 9.

conclusions, emphasizing the role of competition over ownership structure in their interpretation of the evidence. They recognize that in practice privatizing is likely required to create competition, particularly in case of contracting out, and that empirical evidence varies when considering competitive and monopolistic industries, with privatization being less effective in the latter and regulation playing an integral role with respect to outcomes. Boardman and Vining's (1989) literature review comes to similar conclusions, with "an "edge" for the private sector, but results vary[ing] considerably across sectors" (p. 5). Like Vickers and Yarrow, they emphasize the importance of market structure, with monopolistic industries and those subject to high degrees of regulation being favorable to public ownership, but they also highlight in the case of contracting out how low information requirements for supervision is also a key factor for better results under privatization. In their own empirical analysis that attempts to control for industry concentration and other characteristics, Boardman and Vining find significant and robust performance differences, with private enterprise consistently outperforming public enterprises, including mixed ownership structures, with respect to profitability and efficiency. In a somewhat more recent literature review, Villalonga (2000, p. 5-9) finds that 104 of 168 studies of enterprise privatization support greater private sector efficiency, but notes that the evidence is not conclusive.

Similar early results were found when looking more narrowly at the contracting out of services, a form of privatization more comparable and relevant to the social service and SIB context. Boyne's (1998) literature review of contracting out in a variety of service areas found that three quarters of studies show that cost was reduced, although only about half of reviewed studies show efficiency gains associated with privatization after some rudimentary accounting for service levels and quality. Hodge's (2000) review of 40 studies examining the cost savings associated with contracting for service found that cost reductions on average were in the range of 8% to 14% (pp. 123-128) with some substantial variation between service type, with the results being driven by high savings in refuse collection, cleaning, and maintenance (pp. 155-156). Hodge makes the important distinction

in his meta-analysis by noting that contracting for services can take place with both private and public-sector agents, and includes contracting between public providers and purchasers in addition to private contractors and finds that the benefit of contracting to a public agent is similar to that of contracting with a private agent. His results suggest that the cost savings are being driven by the contractual relation as opposed to the ownership status of the firm.

Earlier studies of private sector superiority have been questioned on methodological grounds (Boyne, 1998). Others have put forward that once management and administrative costs associated with privatization are considered, savings may be minimal (Globerman & Vining, 1996). Empirical studies of the efficiency of privatization continue to be plagued by the problem of limited data and challenges accounting for differences in market structure, including the degree of regulation and extent of competition (Bel, Fageda & Warner, 2010, p. 554; Vickers & Yarrow, 1988, p. 41). More recent studies have raised questions regarding the earlier consensus regarding the conditional benefits of contracting out while these challenges remain primarily unaddressed.

A more recent meta-analysis of cost studies in the area of water and waste, which has seen extensive experimentation with privatization, concluded that there was minimal support for cost differences between public and private provision, with more recent studies more consistently undermining some earlier results that claimed lower private delivery costs (Bel et al., 2010; See also Bel & Warner, 2008b). These results are not unique, with a large array of studies pointing to greater efficiency of public enterprise or equivalence (Letza, Smallman, & Sun, 2004, pp. 166-167). Studies have also demonstrated that ceding operations to private sector agents has led to service quality reductions, worsening of working conditions, and reductions in responsiveness to end users (Hermann & Flecker, 2013; Warner, 2012). This, in addition of expected cost savings failing to be realized, has resulted in growing contracting back in of service and a reliance on inter-governmental cooperation as an alternative to privatization (Dijkgraaf & Gradus, 2013; Hefetz & Warner, 2004; Warner, 2008; Bel & Warner, 2008a).

In a particularly relevant recent review, Petersen, Hjelmar and Vrangbæk (2017), conduct an extensive international literature review of empirical studies published between 2000 and 2014 examining the cost saving associated with contracting out. Their sample of 49 studies is more diverse than previous reviews, including studies of “technical services” such as waste collection, transportation, and water services, but also social service areas including health, education and training (pp. 9-17). Two of their key findings include: a steady decline over the study period of the cost advantage of private sector delivery, with studies published between 2010 and 2014 holding an average cost difference of only 0.4 percent (p. 19); and effectively zero cost difference over the entire period between public and private delivery for social services.<sup>13</sup>

They point to advancements in theory based on transaction cost literature to explain their results (p. 19). This work emphasizes how attributes of a particular service can alter the expected benefit of contracting out, where industries with highly specific assets and high cost of performance monitoring and transactions cost more generally are less likely to generate savings (p. 4). Social service provision is such a case (p. 19). There is also a related temporal case to be made that the benefits of privatization will decline overtime as governments will first privatize the services where cost reductions are the most likely, leading to diminishing returns to privatization, and as contracting out takes place, public-sector competitors will learn, adapt and become more efficient when faced with the prospect of elimination (p. 5). A third key finding is a significant difference in effect between Anglo-Saxon countries, who face less regulation and relatively low collective bargaining coverage of the private sector workforce and have cost reductions on average of 6.4%, and other countries who on average saw a cost differential of 2.9% (p. 20), suggesting that privatization may lead to cost reductions simply by reducing worker wages and benefits. Petersen et al. caution the cost savings estimates of

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<sup>13</sup> Petersen et al. note that many of the studies do not account for transaction costs associated with contracting out (p. 18). These cost difference estimates then are likely biased in favour of private delivery. They also note that despite effort to control for comparability of service, “public sector organizations deliver a broader range of services...[and] are often required to serve all citizens in a given area, while private companies can often choose their markets and services” (p. 21). They also reference the challenges of comparability, controlling for competition, and methodological challenges with estimating costs (pp. 21-24).

earlier reviews of privatization studies may have generated smaller estimates if a greater diversity with respect to service types and geography were included in the samples (p. 20).

The inability of the private sector to outperform public delivery in the area of social service delivery is also reinforced in country-level comparative studies of old age security and healthcare (Stiglitz, 2013, p. 220), the two largest areas of social public expenditure in OECD countries.<sup>14</sup> The performance of privatization in the education sector in the United States though the charter schools' movement has also been accused of producing dismal results (Fabricant & Fine, 2012).

Recent studies of private public partnerships (PPPs) in infrastructure, a partial privatization model very similar conceptually to SIBs, in that they rely on private financing and the contracting out of management responsibility that have become popular in Canada, the United Kingdom, and Australia, also show that this form of privatization is at best ambiguous from an efficiency perspective. Loxley (2010) reviews eleven PPP projects in Canada launched between 1994 and 2007 and found that four of the projects generated no savings, two did not have a public-sector comparator to form the basis of an analysis, and three generated savings but these came at the expense of lower labor compensations through the substitution of non-union for unionized labor (p. 173); and in many cases transaction costs were not properly accounted for (p. 174). Vining and Boardman (2008) provide similar assessment of 10 Canadian PPPs concluding that "evidence suggests that the benefits are often outweighed by contract costs and externalities" (p. 38). In a 2009 international review of PPPs, Hodge and Greve find that studies looking at value for money were approximately equally split as to whether the PPP model provided superior results, and in their 2017 study continue to find reviews of PPP value-for-money studies making up the evidence base for PPPs producing inconclusive results and continuing to suffer from methodological challenges (p. 65).

While the a priori evidence on PPPs is inconclusive, the ex post analysis also raises doubts. Shaoul's (2005) review of the PPP Private Financing Initiative in the United Kingdom demonstrates

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<sup>14</sup> Old age security and healthcare make up on average 8.4 and 6.0 percent of GDP respectively in OECD Countries (OECD, 2018).



that the optimistic projections used in value-for-money analysis to justify the model regularly do not materialize in practice, and finds that the PPP projects faced higher costs with minimal risk transfer than conventional procurement. Chong, Huet, Saussier & Steiner's (2006) regression analysis of over 5,000 water providers in France find that PPPs lead to higher prices for consumers, all other things equal, and speculate that this may be due to reduced competition and high transaction costs of the PPP model. A number of studies highlighting the large number of renegotiations of PPP contracts (Estache, 2006; Guasch, Laffont, & Straab, 2006, p. 56; Whitfield, 2017) also suggest that value for money analyses may have been overly optimistic. Whitfield (2017) for example reviews a number of problematic PFI cases where government has had to intervene in previously negotiated PPP contracts, with his analysis finding that a significant proportion, approximately one third of all agreements, when measured by the contract value, have had "buyout, termination or major problems" (p. 7).

While some early studies of privatization produced significant cost saving estimates, more recent studies of contracting out and PPPs bring into question the existence of net cost reductions through efficiencies arising through greater reliance on the private sector for public service delivery. SIB proponent claims that rely heavily on the superiority of private sector management are not on a solid footing in this regard. Social service provision, both based on theoretical developments with respect to asset specificity, monitoring and transaction costs, as well as empirically, appears to be a poor candidate for efficiencies through contracting out. Factoring in that in the SIB case the private sector management benefit is being tapped through an investment from investors that may not have any specific knowledge, management experience or specialization in social service delivery, and may be relying on a hired intermediary to manage its interests, this claim becomes even more tenuous.

#### *Private Sector Innovation Evidence*

Investigations into the innovative capacity of the private sector also challenges private sector superiority. Mazzucato (2015), for example, makes the case that in fact it is often the state that leads

the way with respect to key technological innovations, with the private sector stepping in to commercialize and mass produce once feasibility of the innovation has been demonstrated, even then often requiring additional subsidies and incentive at the commercialization stage. Rather than the state simply offsetting the gap between social and private returns in technological advancement, or playing a coordinating and facilitating role in creating “systems of innovation”, historically revolutionary technological change has been driven by “an entrepreneurial state acting as a lead risk taker and market shaper” (pp. 16-17). She points to the development of the internet, several foundational technologies underpinning the iPhone, the telegraph line, nanotechnology and green energy as all areas where government research led the way. Stiglitz (2015) echoes this message and supplements it by noting other major technical advancements in the US, including “the transistor, the laser, the CCD, information theory,... the programming language UNIX” and radio astronomy were made by Bell Labs, a monopoly funded by an effectively universal research tax (p. 9). Stiglitz (2015, p. 5) also points to research showing that scientists are driven more by the recognition of their work by the scientific community than by financial gains, and that increasing the ability to generate private financial gain through patent protection to stimulate new discoveries, may actually hinder innovation by reducing the pace of and opportunity for incremental discovery through greater privatization of knowledge and limiting the diffusion of new ideas.

Chang (2003, pp. 52-57) also highlights how innovation in a modern economy not only must coordinate dispersed knowledge that has been increasingly institutionalized in organizations as opposed to individuals, but often requires a central agent to formulate a vision, navigate interdependencies, and generate a new institutional structure that may require a reorganization of existing property rights. He points to the “enormous potential gains from good state entrepreneurship” (p. 57) and the “socialization of risk” (p. 136) as a key factor in the innovation and growth observed in capitalist societies.<sup>15</sup>

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<sup>15</sup> See also Rowthorn and Chang’s (1992) discussion of “dynamic efficiency” and the potentially strategic position of the state (pp. 12-13).

Mazzucato's and Stiglitz's research, which focuses on revolutionary technological transformations related to information technology and advanced manufacturing, and Chang's work, which focuses on economic development more broadly, could be argued applies equally to the potential for private capital to generate social innovation and produces an equally if not more critical prognosis in the SIB case. In information technology and advanced manufacturing, the intellectual property rights infrastructure is in place to facilitate the private appropriation of financial gains from successful innovation, yet still private actors have been too risk adverse to pursue truly transformative innovation. The fact that social service delivery not only would generate highly dubious, if any, patenting opportunities for successful innovation while still resulting in the privatization of knowledge, and that the only consumer base for services would be government itself, leads one to believe that it would be even more difficult to stimulate any significant innovation from private actors through SIBs. Additionally, social innovators could be expected just as much as scientists to experience success through non-pecuniary gains, and in particular, value the social impact of their discoveries. Finally, resolving social challenges of poverty, social exclusion and precariousness, involve tackling interdependencies associated with the negative outcomes with respect to the policy areas spanned by SIBs. Moving from a state of high inequality and social exclusion to one of greater equality and social integration will likely involve the type of institutional regime shift described by Chang, and is unlikely to be accomplished by parceling out contracts to address the individual symptoms such as homelessness, unemployment, poor educational outcomes, and unsafe home environments for children, that are tracked as a basis for success.

### c) Pay for Success

Some SIB proponents have depicted the fact that government only pays when projects are successful under an SIB as a self-evident positive attribute of the model (Greenblatt & Donovan, 2013, p. 19; Butler, Bloom & Rudd, 2013, pp. 58-59) and that funding 'what works' over those that don't is the "obvious approach" that governments should adopt (Callanan & Law, 2013, p. 80). This is based

on the idea that service providers are “street-level bureaucrats” in that they have discretion on the front lines of service delivery (Heinrich, 2011, p. 231; Lipsky, 2010), that they respond to financial motivation, and to better achieve desired objectives they should be paid by results. The financial reward may be valued directly, and/or it may be a mechanism to recognize higher achievement, providing a reputational benefit (Heckman, Heinrich, & Smith, 2011a, p. 43).

The general idea of linking individual payment to outcomes in the analysis of production management processes has a long tradition going back at least to Taylor’s theory of scientific management (Rinehart, 2005, p. 40), and an even longer tradition historically in practice through the piece-rate-based cottage industry system, with PbR in social services going back to at least the 1970s in the United States (Pauly & Swanson, 2017). In economics, the analysis and rationale for this payment mechanism is often structured in a principal-agent framework, where an agent who is being contracted to do the work will know better than the principal how hard they are working to achieve the goal set by the principal. By setting a compensation structure based on some verifiable outcome that is observable, the principal can extract a greater level of effort from the service provider, if for example, the principal benefits from greater effort and the agent prefers less, *ceteris paribus*. Alternatively, performance-based contracts can arise when the preferences of government and the service providers do not coincide with respect to the type of outcomes desired, including who benefits from the service and to what degree, and a more prescriptive contract detailing provider activity is not efficient or feasible (Heckman, Heinrich, & Smith, 2011a, pp. 37-39).<sup>16</sup>

There are complicating factors that challenge the simple idea that paying fully based on outcomes is optimal for the principal. First, “best-to-best” models are not an uncontested notion, and run counter to needs-based models where poor performance can indicate a higher level of need, calling for greater resource allocation (Bevan & Hood, 2006, p. 519). In other words, there may be

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<sup>16</sup> Heckman, Heinrich, & Smith (2011b, p. 39) note a third possibility, that performance standards can be implemented as a means to convey data and provide an assessment function.

diminishing returns to investment in well-performing areas and increasing returns in underperforming areas. Halpern and Jutte (2013) make a parallel argument in the analysis of the ethics of PfS, noting that simply allocating based on efficiency and cost saving considerations raise significant equity concerns. Considerations such these will impact whether PbR can be a means to improve allocative efficiency. Even if issues of allocative efficiency can be set aside and one accepts that programs that are thriving merit further support at the expense of others, a proper evaluation should look at both the outcomes and the costs of generating those outcomes. Compared to a standard fixed-price contract and typical economic assumptions, the private sector consortia in an SIB is going to need a financial incentive for taking on the additional risk associated with non-payment under an SIB (Fox & Albertson, 2011, pp. 404 & 411). This raises the relative cost of the contract. Not only will contractors need to be compensated for any reduction in the expected profit due to the chance the project may fail, if the private sector investors are risk averse, they would require further additional compensation. This may lead to the intervention being costlier than if undertaken under a conventional procurement model, unless it is offset by other efficiencies associated with the SIB model.

Another complicating issue is that high-powered incentives based on selective or narrowly defined performance measures may generate unintended consequences that may work counter to program objectives. Dixit (2002), an economist working within the general incentive theory paradigm, summarizes how the unique attributes of public-sector operations may undermine the net benefits of PbR type structures. He notes that while performance-based incentives may facilitate improvements in some element of the principal-agent relationship between management and service providers, they may also simultaneously generate unintended negative consequences.<sup>17</sup> Some of the public-sector attributes he identifies include: (1) the presence of multiple principals due to public

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<sup>17</sup> See Prendergast (1999) for a review of some of these and related challenges to the effectiveness of incentives including signal noise, multiple objectives and the resulting opportunities to game indicators, and career concerns.

goods attributes or externalities associated with goods and services provided by the public sector; (2) concerns of principals with the technique of production in addition to the outputs, including distributional issues and the quality of jobs created; (3) branches of government that deliver services to the public generally are responsible for meeting a number of objectives with attributes that impact consumers on multiple dimensions, many of which may be difficult to measure; (4) competition in the areas in which public services are provided is often non-existent and when created through privatization or procurement can create problems due to hard to measure multi-dimensional outcomes of concern to multiple principals; and finally, (5) the presence of career concerns, professional integrity, and a public-sector work ethic based on norms of public service that can substitute for private financial incentives (pp. 711-717).<sup>18</sup> While the ideal is to set up targets that are “specific, measurable, achievable, relevant and time-limited”, the public-sector context creates challenges for such effective metrics to be constructed that correspond directly to the often-complex multifaceted goals of public service delivery (Lagarde et al., 2013, p. 8).

Target-based systems may convert individuals who previously put the best interests of the system first or at least did not try to conceal negative outcomes, into strategic agents who seek to take advantage of narrow performance indicators (Lowe & Wilson, 2017). There is extensive empirical evidence, for example, that the introduction of pecuniary incentives can lead to the displacement of intrinsic motivation with long-term detrimental effects on performance (Bénabou & Tirole, 2003, p. 490; Bénabou & Tirole, 2006). The introducing of such schemes may be interpreted as lack of trust or expression of non-confidence on the commitment or ability of agents, who in turn may reciprocally respond by behaving in a more self-regarding manner. Performance based compensation then may generate “incentives to ‘cheat’ both by target-setters and target managers” (Bevan & Hood, 2006, p. 519). In the narrower case of PbR employment contracts, these and other

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<sup>18</sup> Others who have proposed that public service employees may be motivated to provide additional uncompensated labor time or effort stemming from a public service ethic include François (2000), Groot and Sonderegger (2006), and Glaeser and Shleifer (2001).

“dysfunctional behavioral responses” arise given that payment is based on indicators that at best represent only a subset of the relevant attributes of work performance, and that the worker – manager relationship generally cannot be fully specified in a verifiable and enforceable contract (Prendergast, 1999, p. 8).

In practice, performance standards will often be based on short term indicators given the logistical infeasibility of delaying payment to service providers for long periods of time. In the area of workforce development, examples include using measures such as employment rates or earnings in the first few months after training (Heckman, Heinrich, & Smith, 2011a, p. 33). The outcomes measures used in practice are highly simplified and disconnected from the multi-faceted complex realizations of success that programs aim to achieve, resulting in the potential for reported outcomes to diverge from the reality they aim to proxy (Lowe, 2013; Lowe & Wilson, 2017), particularly when outcomes take an extended amount of time to be fully realized. In this context, one cannot tell if positive performance measures indicate (1) positive outcomes across all service areas, including those not monitored or imperfectly monitored by the chosen indicators; (2) positive outcomes in the well measured activity area at the expense of poor performance on unmeasured or imperfectly measured activity/cost shifting; (3) poor outcomes and an emergent disassociation between performance measures and outcomes due to strategic gaming, or (4) poor outcomes and outright data fabrication (Bevan & Hood, 2006, pp. 522-523).

Gaming in this context refers to the modification of activity or reporting behavior in response to incentive-based payments or performance standards in a way that may negatively affect service output. For example, contracted service providers may modify the number of clients they serve, which clients they service, and how much effort they dedicate to servicing each client (Heckman, Heinrich, & Smith, 2011a). Exclusively self-interested entities will increase their expected compensation by shifting effort from unmeasured to measured indicators (Prendergast, 1999, p. 8). When targets are based on achieving thresholds, strategic players that are underperforming will be

incentivized to increase effort to meet the threshold targets if feasible and otherwise abandon efforts altogether until the next round; and overachievers will be incentivized to reduce performance or shift output from the current period to the next (Bevan & Hood, 2006; Dixit, 2002). Bevan and Hood's (2006) review of performance-based targets in UK Healthcare for example identified gaming effects in a "significant minority of service provider units (ranging from 7 to 33 per cent in the studies quoted)" (p. 532). In active labor market programming, there have been some dramatic gaming examples, with private contractors who had paid multi-million-dollar dividends to owners being prosecuted for fabricating data on employment outcomes (Syal, 2012). Bevan and Hood suggest an alternative of abandoning specific performance measures, and issuing only general standards, or not specifying thresholds in advance, and auditing to verify data integrity and coherence of indicator measurement and service objective intent with in-person evaluations including direct interaction with staff (pp. 534-535).

Courty & Marschke (2011a) develop a formal model of the negative and unintended behavioral responses that performance standards can elicit from service providers who take actions to increase reported outcomes, and classify them into three categories: *accounting manipulations*, which are responses that costlessly boost reported metrics but do not impact outcomes; *gaming responses*, which increase reported performance but have a direct negative effects on realized but unmeasured outcomes, and *marginal misallocations*, a shifting of resources between activities that individually creating a positive impact on reported outcomes, but results in a reduction in the aggregate benefits of the service provided due to resources being shifted away from positive activities that produce unmeasured positive outcomes. They cite evidence in their literature review of all of three activities in health and education where performance measures were introduced (pp. 212-214).

Two specific gaming effects discussed in the studies of PfS social service delivery, especially in the context of active labor market programs, are *cream skimming* and *parking*. Cream skimming refers to the case where program intervention participants are selected by service providers to



minimize effort or resources required to meet the outcome objective, as opposed to “individuals’ expected long-run benefits from participation” (Heckman, Heinrich & Smith, 2011a, p. 30). Parking refers to hard to serve clients only being provided with low-cost, low-quality interventions with minimal chance of generating meaningful positive outcomes for these clients, while focusing effort on those more likely to successfully meet threshold targets (Finn, 2008, p. 11).<sup>19</sup> Parked clients may still end up succeeding due to non-program related factors including their own motivation, so the agent may still receive incentive payments for the client despite not being responsible (Finn, 2008, p. 40).

Heckman, Heinrich, & Smith, (2011a) develop a formal model of cream skimming based on the initial assumption that training providers are driven by the desire to maximize the net present value of intervention impacts. They demonstrate how the introduction of short term performance incentives can lead to a reduction in the generated benefits of the program in the case that those who are easiest to serve, i.e. those that have best outcomes in the case of not receiving training supports, are not also those who benefit the most from training services. The introduction of performance incentives in this case may lead to a misallocation of training services away from where it can generate the greatest benefit towards meeting targets and can have negative equity impacts, with services being reallocated from those who are worse-off to those who are easier to achieve a targeted threshold.<sup>20</sup> In the case where the service provider has preferences other than maximizing benefits, such as having a “social worker mentality” (p. 48) where the trainer provider prefers servicing the worse-off regardless of whether they benefit relatively more or less from the training intervention, performance indicators can incentivize trainers to more efficiently allocate resources. They conclude by highlighting the “the difficulty of designing a performance system that makes things better (rather

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<sup>19</sup> The concept of parking appears in other pay by results contexts, such as in education where teachers being reimbursed based on student test scores are incentivized to transfer effort to students whose scores respond strongly to teacher attention away from students whose scores are less responsive (Murnane & Cohen, 1986, p. 5).

<sup>20</sup> While cream skimming includes decisions regarding who to accept into programming as well as allocating individuals to different types of programming, cream skimming activities can be more covert, including offering services that may appeal to certain groups, strategically locating service delivery and targeting outreach efforts, to increase the odds of easy to serve clientele participating (Heinrich, 2011, p. 236).

than making them worse), as well as the dependence of the effects of performance standards systems on empirical parameters that remain generally unknown and little investigated” (p. 57).

Cream skimming in SIBs can be avoided if a strict randomization of clients is undertaken between the treatment and control group (Liebman & Feller, 2014, p. 26), but this may be challenging in practice. Gaming more broadly can be counteracted by establishing independent and external monitoring and evaluation bodies (Bevan & Hood, 2006, p. 519) and clearly specifying relevant client characteristics, accepting and categorising clients according to these criteria, and compensating service providers more for harder to serve clients. This however can lead to greater administrative requirements, depersonalized service, disputes and postponement of service to clients (Finn, 2008, p. 40). In general attempts to address creaming and parking issues arising in PbR schemes may undermine the flexibility and space for innovation that motivated outcomes-based payments in the first place (Finn, 2008, pp. 24, 39). Responding effectively to gaming will also be resource intensive, as agents learn and adapt to PbR schemes, altering their behaviors overtime (Heinrich and Marschke, 2010, p. 203). Rather of being of universal benefit to governments as claimed by some proponents, PbR structures are complex to implement, may not be suitable in many contexts and can have a “negative impact on value for money” (Morse, 2015, p. 7). Given the potential negative consequences of PbR payment structures, empirical research is reviewed below on the effectiveness of the PbR contract structure.

### Empirical Evidence on the effectiveness of PbR Initiatives

While comparative studies of SIBs versus conventional delivery are lacking, more traditional PbR models in public service delivery have a longer track record and have generated more comparative analyses of how PbR performs in practice. These studies raise doubts regarding the ability of PbR to generate improvements over more conventional delivery frameworks and several authors have noted the transferability of problems arising in PFS contracts to SIBs (Fraser, Tan, Lagarde & Mays,

2018, p. 15; Lagarde et al., 2013; Maier & Meyer, 2017, pp. 5-6). These studies include examination of PbR in the fields of education, healthcare, and active labor market programs.

### *Education*

In education, the payment of teachers based on outcomes, specifically how students perform on standardized testing or teacher evaluations, has a long history, going back to the late 1800s in the United States (Podgursky & Springer, 2007, p. 911) and the 1860s in Britain (Coltham, 1972, p. 19). Studies of the PfP implementation in the late 1800s of PbR in Britain demonstrated that teachers adjusted teaching practice based on what was tested, dropping subjects that were not on the assessment test, increased severity of punishment in the classroom, falsified records, and improperly assisted students during examinations, leading investigators and scholars to berate the PfP system and its detrimental effects on both teaching, curriculum, and attractiveness of the profession (Coltham, 1972, pp. 24-28). In the presence of growing teacher organizing and professional concern for the state of the profession and working conditions, at the turn of the century the PfP system in Britain was eliminated and was eventually replaced by a salary-based system for the vast majority of teachers (Coltham, 1972, pp. 30-31; Podgursky & Springer, 2007, p. 911-912).

For similar reasons, early PfP incentive systems in US education fell in prominence in the mid-1900s, although persisted in a minority of schools (Murnane & Cohen, 1986, p. 2).<sup>21</sup> An early experimental evaluation of privately provided PbR teaching relative to standard salary based public education in the US saw both threshold and parking effects (Murnane & Cohen, 1986, p. 5) and minimal to no positive impact, although the experiment was limited to one year and faced several administrative and logistical challenges (Gramlich & Koshel, 1975). Based on interviews in six identified school districts with 10,000 or more students that had used substantial incentive pay for

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<sup>21</sup> Murnane and Cohen (1986) reference many of the same reasons as Dixit (2002) does for public sector more broadly as to why incentive based pay would not be effective in a school setting, including team production and the collaboration required to create a positive school learning environment, the pursuit of multiple objectives with many being hard to measure, and the potential displacement of intrinsic motivation, and emphasize how PbR structures undermine collaboration and the gains of rewarding the top teachers can be offset by the discouragement of others.

five or more years, Murnane & Cohen (1986) discovered that these districts that had maintained PFP modified the structure significantly, to alternative systems that provided “extra pay for extra work”, “quietly awarded merit pay to almost all teachers” which “make[s] everyone feel special”, or were accessed by only a small number of teachers and therefore had minimal salience, with the latter two also requiring significant administrative effort to apply for bonuses (pp. 13-14). All of the identified districts were desirable from a working conditions and baseline salary perspective, and merit pay was deemphasized, with staff discretion often being encouraged with respect to award amounts. The districts also had teachers themselves designing the incentive-based reward structure with long-standing programs restructuring their PFS systems overtime. Murnane & Cohen (1986) conclude that these merit pay schemes, as opposed to being typical PFP structures, are one of many options used to facilitate payment tied to hours of work, better communication between teachers and the administration regarding best practices in the classroom and how evaluations should be structured, as well as higher overall teacher salaries paired with accountability to the broader community. In many contexts they argue more typical PFP structures will work counter to these goals. (pp. 12-17).<sup>22</sup>

PFP payment schemes in the US have seen renewed interest recently, with the federal government’s Department of Education programs such as the Teacher Incentive Fund launched in 2006 and Race to the Top Fund launched in 2009, encouraging the incorporation of teacher performance into compensation practices with the aim of both improving teach productivity and selection into the teaching workforce. One well known example of modern PFP teacher schemes is the IMPACT teacher-evaluation system in the District of Columbia, which uses a combination of teacher assessments and student test scores to determine both terminations for low performing teachers and significant financial bonuses for high performing teachers, while also providing support for improving performance through professional development resources and helping teachers

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<sup>22</sup> Another alternative of these input-based compensation schemes, for example, is “knowledge- and skill-based pay” that reward teachers based on the acquisition of incremental new teaching capabilities, although studies have not produced evidence of its effectiveness (Podgursky & Springer, 2007, p. 913-914).

understand the link between their actions in the classroom and assessment scores (Dee & Wyckoff, 2015, pp. 268-269). There are many other similar PFP systems that are or have become recently operational, including the North Carolina ABC, the Denver Procomp program, and the Minnesota Qcomp initiatives (Neal, 2015, pp. 510-515). PFP systems also saw a resurgence in England with the *Performance Related Pay* initiative launched by the central government in 1999. Under the system, based on a threshold application process, which if met initiates entry to an annual PFP scheme (Atkinson, Burgess, Croxson, Gregg, Propper, Slater & Wilson, 2009, pp. 252-253).

Research supports that these incentives are altering teacher behaviour, with threshold and parking effects have being observed (Koning & Heinrich, 2013, p. 4). Neal (2011, p. 509-515) summarizes 17 modern teacher incentive systems aimed at increasing instructional quality primarily through financial incentive bonus but also teacher screening. Neal finds of the 14 where independent evaluations were conducted, all but four resulted in improved test scores for student subsets in some subject areas, again suggesting teachers do respond to incentives. While the incentives are altering teacher behaviour, there is minimal evidence with respect to how these compensation schemes are affecting quality (Dee & Wyckoff, 2015, pp. 269-270).<sup>23</sup> Neal highlights that one can not be certain if improved test results indicate an overall generalizable improvement in student skills or if teachers simply shift effort towards teaching to the test.<sup>24</sup> Studies explicitly examining this issue by comparing alternative student evaluation methodologies show “in some cases but not all, these gains appear to reflect improvements in general student skills” (p. 519). Neal recommends a full separation between testing tools that assess system performance and those used to pay bonuses to teachers, and moving to fixed total award incentive schemes where teachers are paid a bonus based on the pure relative

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<sup>23</sup> Research does suggest at least in one case that increased evaluation alone can lead to quality improvements that persist and grow after the year of evaluation (Taylor & Tyler, 2012), highlighting the importance of separating the impact of PbR payment structures from the direct benefits of evaluation paired with improvement guidance that may be part of larger PbR initiatives.

<sup>24</sup> Following Koretz (2002), he names three types of teacher behavior that can lead to improved test scores but not less to the development of generalizable skills: narrowing of subject matter, coaching to specific testing methods, and straight out cheating. Podgursky & Springer (2007) review a number of documented actions in response to modern PFP incentive structures including teaching to the test, move students into special education streams, helping students on exams, grade manipulation, suspending low performing students on exam days, increasing student calorie intake on exam days, and administrative manipulation.

ranking of students on tests that vary substantially with respect to form and content overtime to prevent teaching to the test, although he notes these schemes are still vulnerable to cheating by teachers and can generate “wasteful forms of competition” (p. 547).

There is also some evidence that creaming effects are also at play in PFP-based school systems. A unique case of mass privatization of the education system took place in New Orleans in the aftermath of hurricane Katrina, with a large proportion of the school system being transferred to charter school administration. Recent studies have highlighted and suggested gaming and creaming activity occurring alongside increasing test scores in this context (Harris & Larsen, 2016; Jabbar, 2015).

To summarize, incentive pay schemes in the education sector have been historically fraught with challenges and controversy, and while evidence is clear that financial incentives do alter teacher behaviour and have been associated with higher test scores, it is not clear if overall these changes benefit or harm student acquisition of generalizable knowledge and skills. The literature does however point to various adaptations to the PFP framework that may make these schemes more likely to generate beneficial outcomes.

#### *Active Labour Market Programs*

Active Labor Market Programs (ALMPs) were early modern adopters of PFS programs, with the United States being one of the first adopters (Finn, 2009, p. 40). One program that has been subject to in-depth research, due to high quality data and control group samples, is the US Job Training Partnership Act (JTPA) - succeeded by the Workforce Investment Act (WIA) - which allocated funds to training centers across the United States, partially based on trainee outcomes (Heckman, Heinrich, & Smith, 2011d).

The JTPA directed incentives to be based on identifying the impact of training interventions, but the high cost of isolating impacts of interventions was prohibitive (Courty & Marschke, 2011b, pp. 72-75). The incentives utilized in the JTPA ended up based on the employment and earning rates and movement from welfare to employment upon completion and at a three-month follow-up; for youth,

completion of training and education benchmarks were also used (Courty & Marschke, 2011b, pp. 72-75). Performance standards were in some cases adjusted based on the composition of the trainee pool served by the training center, creating the potential for trainers to alter their participant pool to reduce thresholds for performance payments (p. 81). Later, individual states, which had some flexibility with respect to performance incentive measures, took steps to take into account demographic considerations aimed at encouraging training centers to enroll harder to serve groups and also rewarded centers that spent more of their allocated budget (pp. 82-83). The WIA also incorporated similar changes on a system-wide level upon succeeding the JTPA. There was significant variation between states with respect to how they allocated performance payments based on the discretion provided by the federal government in set incentive schemes, leading to the emergence of binary, linear and non-linear systems (p. 84).

This JTPA incentive structure impacted the behavior of service providers (Heckman, Heinrich, & Smith, 2011a, p. 33) and led to the potential for several incentive problems, including rewarding cream-skimming and limiting intake, as well as shifting activities from longer term training interventions that may have delayed but greater benefits, such as education and training, to interventions which may have more immediate impacts on a larger number of participants, such as job search assistance (Courty & Marschke, 2011b, p. 76-78). The system also generated the potential for threshold effects (p. 78), with evidence that training centers were manipulating their client populations temporally to enhance their measured performance (Courty, Kim & Marschke, 2011a, p. 116).

Heckman and Smith (2011) uncover some “suggestive, but not definitive”(p. 162) evidence in support of “modest” (p. 196) cream skimming in their analysis of program data, but caution that the disparity between the eligible population characteristics and that of trainees is also driven by differentials in program awareness and program participant requirements amongst population groupings. Noting that cream skimming has ambiguous effects on efficiency depending on the

correlation between ease to serve and the incremental impact of training services, Heckman, Heinrich, and Smith (2011c) find that the efficiency impact of cream skimming in the JTPA was minimal, and in some cases where resources were allocated away from the hardest to serve, may have increased it. Heckman, Heinrich, & Smith (2011c) conclude that “the cream skimming problem is overstated” ... and that “personal choices and lack of information play the major role in accounting for demographic disparities in participation. Administrative discretion... is not the dominant factor” (p. 309).

Courty & Marschke (2011a) in their analysis of JTPA data also uncover evidence of “strategic reporting” which inflated employment rate outcomes by 11.3 percentage points (p. 215), threshold effects where participants were shifted between reporting periods with evidence that this came at the expense of productive activity and participant earnings outcomes (p. 218). They conclude that: ...dysfunctional responses that imperfectly conceived performance measures engender can undermine the organization’s mission. These costs make the use of performance measurement systems uneconomical for many public-sector organizations because they raise more management problems than they solve. This may explain why such organizations rarely implement explicit performance measures (p. 224).

These types of behavioral responses have been confirmed by case studies of JTPA training providers (Heinrich, 2011).<sup>25</sup>

Additionally, Heckman, Heinrich, and Smith (2011c) find that the use of short term measures negatively impacted programming decisions from an efficiency perspective as short run measures in general had no relation to long-term outcomes, with some evidence that they may be negatively correlated such that positive short-term indicators, such as immediate employment, had negative long-term outcomes in areas such as earnings growth and long run employment prospects. They note

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<sup>25</sup> The WIA implemented changes in reporting structure to reduce manipulation (Courty & Marschke, 2011a, p. 218) and took additional steps to limit creaming through payment schedules based on client characteristics but selection bias within subgroups persisted (Courty, Kim & Marschke, 2011a).



that this result based on their literature review does “not represent an anomaly in the [employment and training] literature, but rather tell much the same story as the other studies that perform similar analyses” (p. 292). They highlight the limitations of their analysis including the reliance upon randomization assumptions and the equivalence between those applying and those accepted into programing, which may ignore some screening effects. Also, their analysis does not consider an increase in “technical efficiency (or productivity)” (p. 293) stemming from the incentive effect on service provider effort that may be generated by the pay by results structure in JTPA. The challenges faced by the JTPA program are consistent with previous findings that PfS projects have not performed as expected and have been under resourced with respect to monitoring and evaluation (Heinrich & Marschke 2010, p. 184) and the underestimation of the challenges inherently faced as the systems and behavior evolve overtime (Heckman, Heinrich, & Smith, 2011c).

Finn (2008) reviews two active labor market PbR models, the Austrian Job Network launched in 1998 and refined over a decade of implementation, and the Dutch Reintegration Market initiated in 2002 in the Netherlands. These programs differed from the JTPA program in that incentive payments made up a large proportion of the compensation to service providers (pp. 17&33). Both programs were found to reduce costs and increase the number of participants served (p. 5). Successful employment rates in the near term improved in the range of 5-10% and matches were made in a shorter timeframe in more conventional programs. Finn’s review suggests similar shifts occurred as under the JTPA, with higher employment rates achieved in some cases by focusing on job search assistance at the expense of training programs and sponsored work placement, with “negative consequences for the quality of service delivery for the most disadvantaged” (p. 39). While the cost savings were clear, Finn notes that “relatively little is known about the extent to which these gains have been offset by high transaction costs for the purchaser, providers and service users” (p. 5). Finn notes that the movement to PbR systems, in both Austria and the Netherlands, led to a reduced ability of government to effectively manage programming and increased contract management and

administration costs. Both parking and creaming effects were observed in both countries, despite differential payment structures based on classifying clients. Program modifications to address these problems slowed service delivery, reduced flexibility to pursue innovative solutions, and led to an increase in administrative costs (p. 40). Finally, Finn highlights how private service providers may cease operations while under obligation to deliver service, which has occurred in both countries, imposing costs and requiring reaction from the state to shore up the gaps created (p. 44).

In the United Kingdom, incentive payments in ALMP began in 2002 with the launch of the Jobcentre Plus, a revamped public-sector agency delivering job market programming and benefits. A study of the introduction of incentive payments for service teams based on client outcomes found that, in aggregate, the benefit of incentive payments was nil, although smaller teams and service delivery areas had better results (Burgess, Propper, Ratto & Tominey, 2012). The next step to PFS contracting in ALMPs in the UK was triggered by the 2007 Freud report, which recommended addressing the skills gap for low and unskilled workers relative to other advanced countries by contracting out ALMP service delivery through PbR contracting. This was implemented first through Labour's Flexible New Deal, which saw challenges with service provider bankruptcies (Finn, 2008, p.44) and later deepened through the Conservative-Liberal coalition's Work Programme, which made payments almost exclusively based on outcomes (Rees, Whitworth, & Carter, 2014, p. 224). The Work Programme attempted to address problems of creaming and parking effects present in the previous program by using nine classification categories to determine payment structure, although evidence suggests that this has not been effective (Morse, 2015, pp. 28-29; Rees et al., 2014, pp. 228-236). A 2014 evaluation of the program determined that outcomes were comparable to its precursors and provided costs savings, although this was based on a hypothetical counterfactual (Morse, 2015, p. 37).

## *Healthcare*

Several literature surveys of the relationship between PbR schemes and patient outcomes have taken place in the healthcare field (Lagarde et al., 2011, p. 19), and the conclusions of these surveys vary substantially based on the restrictiveness of their inclusion criteria. Scott et al. (2011) conducted a review of studies examining PbR initiatives in the area of primary care with the goal of assessing the impact on the quality of care provided. Rigorous selection criteria focusing on experimental and quasi-experimental analyses limited the number of studies reviewed to five US studies, one German study and one conducted on services in the UK. Three studies were focused on smoking cessation, one used a patient service quality survey, and three utilized administrative data-based outcome measures based on compilations of various health indicators. They concluded that the schemes produced “positive but modest effects on a minority of the measures of quality of care included in the study”, but expressed concern with the experimental integrity of the studies, in particular “selection bias as a result of the ability of primary care physicians to select into or out of the incentive scheme or health plan” (p. 21).

Christianson, Leatherman, & Sutherland (2007) conducted a detailed review including a review of literature surveys, with significant attention paid to classifying experimental quality, and concluded that “relatively few significant impacts are reported, and it is often the case that payer programmes include quality improvement components in addition to incentive payments, making it difficult to assess the independent effect of the financial incentives” (p. 21). They note that preventative services have been studied more intensively but conclude that the “few studies in this area with strong research designs find small, if any, effects of payments to providers that are intended to improve quality” (p. 21). One of the surveys informing this finding is Town et al. (2005), who limit their inclusion criteria to randomized control trials examining PfP incentive programs designed to increase the delivery of preventative interventions, specifically immunizations and cancer screening, by primary care providers. They observe that only one out of eight studies “found that increasing

financial incentives translated into the provision of more preventive care” (p. 235), but qualify their results by highlighting limited sample size and noting the incentives offered were generally small (p. 148). Other reviews with more stringent criteria or that reported separately randomized control or quasi-experimental evidence also produced similar findings with small or negligible outcome gains (Houle et al., 2012; Mehrotra, Damberg, Sorbero & Teleki, 2009).

In their review of the UK’s extensive PfP system that emerged as a result of the Quality and Outcomes Framework (QOF), and utilizing a less stringent inclusion criteria scoping in 94 articles, Gillam, Siriwardena, and Steel (2012) find “modest reductions in mortality and hospital admissions in some areas, and where they have been assessed, these modest improvements appear cost-effective”(p. 464). They also note a number of systems changes they associate with the implementation of the QOF, including negative outcomes in unincentivized areas of care, high costs, improved collaboration and knowledge sharing amongst medical staff, freeing up doctors for more acute problems, and reduced discretion with respect to treatment. They observe that predictions of mechanistic and impersonal care practices have not materialized (p. 464-465).

Green and Nash (2009), also with more generous scoping criteria, include 36 studies, and obtain more optimistic results with respect to the impact of PFP on patient outcomes, finding that “most have produced positive results” (p. 148). They do note however that distributional considerations are important to consider, with two studies showing a negative impact, and recommend that steps should be taken to ensure that physicians who service disadvantaged populations should not be adversely affected. Petersen, et al. (2006) come to similar conclusions in their review of 17 studies going back to 1980, with 13 studies that produced indicators of quality improvement in the PFP cases, but also identified gaming issues with one study finding reduced access to care while four studies “suggested unintended effects of incentives”(p. 268).

To recap, survey studies of the impact of Healthcare PFP systems on patient outcomes that use narrower scoping criteria emphasizing randomized control trials and quasi-experimental studies

find modest or minimal positive impact of Pfp schemes on patient outcomes, while those with more liberal criteria find more positive results. These results should be viewed in light of the number of issues that create challenges for comparing and generalizing results from various healthcare Pbr initiatives. These challenges include that: merit payments being targeted at different administrative levels - individual healthcare providers, provider groups, or facilities such as hospitals; large variation in the size of incentive between projects; and the co-implementation of various Pbr initiatives and quality enhancements reforms (Christianson, Leatherman, & Sutherland, 2007, p. 15). Some studies have been criticized for having poor association between meaningful outcomes for patients and the measures being tested (Bhattacharyya, Freiberg, Mehta, Katz, & Ferris, 2009). It is likely that the problem of misalignment between narrow outcome measures is as significant a problem in healthcare as in education, as noted above. Studies on Healthcare Pfp programs have highlighted many problems found in other program areas, including gaming, underservice of hard to serve clients, the displacement of intrinsic motivation and professional integrity, and incentive payments going to those who were already performing well (Chen, Chung, Lin, & Lai, 2011; Christianson et al. 2007, p. 15; Epstein, Lee & Hamel, 2004, pp. 409-410; Rosenthal, Frank, Li, & Epstein, 2005, p. 1788).

#### *International Development*

Klitgaard (1997, p. 495-497) identifies a number of Pbr based public service reform projects in the international development context, from a diverse sectors including central government administration in areas such taxation and revenue collection, water treatment, and agricultural credit programs. While arguing that reformed incentive structures are important for developing effective civil services in developing countries, he equally emphasizes the generally low wage rates and the conditional circumstances that are necessary for Pbr to be effective, many of which are not present in developing countries. He notes that Pbr will likely only be successful in contexts where high effort leads to large incremental gains in performance, public service workers with minimal risk aversion

risk due to a reliable capacity to support oneself and favorable alternative employment opportunities, strong monitoring and evaluation capabilities of the state, and employees constructively sensitive to pecuniary incentives. PbR reforms then are only likely to be effective as part of a larger package of reforms aimed at generated these conditions.

Klitgaard suggests that each of these can be enhanced through targeted measures. Outcomes could be made more responsive to efforts by clearly specifying how employee actions impact performance and what actions are expected to lead to better outcomes; consulting employees when setting goals and using participatory methods when designing and undertaking training and evaluation. Employee risk aversion can be reduced “through experiments that can be reversed if they turn out badly, employee self-selection into performance-pay programmes, and credible commitments backed by international organizations”; and evaluation can be improved through “through systematic client surveys, peer reviews, benchmarking, detailed studies of performance samples, ratings by superiors, and other techniques”(p. 499). Finally, employee productivity can be improved through human and physical capital investments.

### *Gaming in SIB Initiatives*

There are concerns that the demonstrated gaming problems in PfS and the displacement of intrinsic motivation may carry over to the SIB model and that success may be achieved through generation of negative externalities (Warner, 2013, p. 13-14). There is some evidence that gaming problems arising in PbR schemes have carried over to the SIB model. While an early review by the OECD suggested that creaming was not notable, others have noted examples in multiple SIB projects.<sup>26</sup> Loxley (2017) who reviews several child welfare SIBs aimed at keeping young children safely with their families, discovers evidence that the Sweet Dreams SIB in Saskatoon, Canada has selected a group of mothers that was more likely to be successful relative to the potential pool of

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<sup>26</sup> An OECD report (Ramsden, Noya, & Galitopoulou, 2016) noted for example that some early UK SIBs did not appear to be facing substantial gaming issues and attributed this to the fact that the contracted service providers were “dedicated social enterprise organisations demonstrating a strong organisational ethos” (p. 16).

participants, and given the lack of a control or comparison group this is particularly problematic. The Benevolent Society Bond in New South Wales, Australia, was also deemed by the auditors to have selected families with lower barriers, although there was similar finding for the control group, so while investors are not advantaged by the selection bias, it may however make the intensive intervention design less appropriate and cost effective (Loxley, 2017, pp. 16-18).<sup>27</sup> The Utah early childhood development SIB, aimed at diverting children from special education services, has also been accused of over-stating the impact of services and selecting clients that were facing fewer barriers than claimed, with educational experts questioning whether the selected children would have ended up requiring special education without the intervention (Popper, 2015; Tse & Warner, 2018b). Additionally, Edmiston and Nicholls' (2018) review of four UK SIBs found that creaming and parking issues arose in these projects, with some agencies indicating that they had to take "measures to 'insulate' their front-line staff from the influence of certain social investors" to avoid the promotion of "dysfunctional practices" (p. 65). This suggests that the inclusion of dedicated value-based organizations may not be sufficient to prevent gaming incentivized by the PbR aspect of SIBs. What could be considered a form of gaming was also utilized in anti-homelessness initiatives led by St Mungo's and Thames Reach in the UK. In addition to helping individuals find housing and employment, they also worked with immigration authorities to deport homeless individuals who did not meet residency UK requirements (see: Bloomer, 2016; Ryan & Young, 2018).<sup>28</sup>

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<sup>27</sup> Loxley (2017, pp. 9-10) finds the opposite case for the Newpin Social Benefit Bond, where out of the eligible population for the program, the vast majority were pulled from the hardest to serve classification where a child has been in care for three or more months, due to court referrals to the program. In this case, the risk for the investors was mitigated through a limit on the number of reversals, where families were reunited but then disintegrated with the child being taken into out-of-home care, that would count against the number of successful integrations.

<sup>28</sup> Although this was explicitly part of their strategy to meet targets (Social Finance, 2018), it raises questions as to whether deportations should or would normally be part of the charitable mandate of these organizations if not for the PbR structure.

#### d) Transaction Costs and Windfall Gains

Both the privatization/contracting out and PfS literature refer to the increased transaction costs that are involved in transitioning from the status quo, be it in-house public delivery or conventional procurement, to these alternative delivery models. In general privatization involves significant transaction costs, related to raising capital, contract preparation, promotion, and other administrative requirements, which can be particularly costly relative to raising capital through traditional government borrowing (Vickers & Yarrow, 1991, p. 118). These challenges are similar for SIBs. Privatization also creates a large onetime payoff that effectively captures the net present value of enterprise operations (Vickers and Yarrow, 1991, p. 118), magnifying the principal-agent problem central to privatization analysis and raising the stakes significantly relative to a contracting-out arrangement that is renewed on an annual basis, creating potential windfall gains for investors (Stiglitz, 2008). Historically, privatization schemes have been marred by questions regarding their legitimacy due to undervaluation and the realization of a significant net transfer of public wealth into private hands (Klein, 2006; Stiglitz, 2008). While SIBs are time limited, the privatization of a quasi-revenue stream that takes place in SIB contracts over multi-year contracts raises similar potential concerns.

In addition to these more general transaction costs and potential windfall gains for private investors, PbR and SIB approaches face a number of model-specific transaction costs stemming from the identification of appropriate metrics and implementing tracking systems and processes, defining the intervention population, generating a control group counterfactual, and the need to specify responsibilities under all scenarios, leading to prolonged negotiation and in some cases renegotiation after the contract is signed (Fraser, Tan, Lagarde & Mays, 2018, p. 14), resulting in higher administration and transaction costs relative to the conventional model (Damberg, 2009; Maier & Meyer, 2017; Tan et al., 2015; Warner and Tse, 2018b; Whitfield, 2015).



Data on three individual SIB projects provides some support for this hypothesis. Loxley (2017) for example finds in the case of the Newpin Child welfare SIB, transaction costs were significant, totaling as much as \$0.75M on a \$7M SIB inclusive of staff time (pp. 7-8). While data is not available, he assesses that the cost would be similarly high on another Australian child welfare project, the Benevolent Society SIB (pp. 15-16). KPMG (2014), also looking at the Newpin SIB, also found the process “very labour intensive for all the stakeholders involved;... [with the equivalent of] six FTEs working solely on the development of one social benefit bond over an intensive 12 month period” (p. 28). KPMG did however note that transaction costs are expected to fall as the model becomes more common and experience is accumulated overtime.

The Reconnections Social Impact Bond in Worcestershire, England, aimed at reducing the negative outcomes for older adults due to social isolation also had high developmental costs of £189,000 for a project based on £850,000 of capital raised, which included estimates of government staff time, the salary of a project manager, as well as a cost benefit model used to estimate the returns to the intervention (Ecorys UK & ATQ Consultants, 2015, p. 5). While the set-up and transaction costs were high at 22%, almost half of this went to the cost benefit analysis and the development of metrics to develop and access the proposed intervention model, which was new and untested to date. The UK Mental Health and Employment Partnership SIB was based on development grant £150,000, awarded to Social Finance, for an SIB project being financed with £400,000 of private upfront capital invested (Hickmann, 2016, pp. 11-13). These partners also appear to have also invested approximately £480,000 of public funds in the project service delivery, which would reduce these development costs to 18% of project costs.<sup>29</sup> Neither of these estimates account for any in-house transaction costs borne by the three local commissioning government partners.

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<sup>29</sup> Authors calculations based on figures in Hickmann (2016, pp. 11-13).

Qualitative assessments also concur that SIBs can be transactionally resource intensive. Ronicle, & Stanworth (2015), for example found that UK's first Health SIB required "a complex web of contracts" (p. 1) whose negotiation, including the determination of appropriate outcome measures caused "significant delays" and frustrated the process (p. 13), with the final SIB launching four years after the first development grant funding was secured (p. 6). Edmiston and Nicholl's (2018) examination of four UK SIB projects noted that "a number of cross-sectoral stakeholders interviewed... felt that the high transaction costs associated with developing the SIB threatened the future cost savings achievable" (p.70).

Some SIBs however have been found to have relatively low transaction costs. For example, Loxley (2017) finds that transaction costs were low on the Sweet Dreams SIB, a Canadian child welfare SIB, due to its simple structure and procurement as a directly-sourced contract without a request for proposals process, although this SIB has faced criticisms with respect to problems that could have been addressed with greater attention at the project design and negotiation phase (pp. 2-3).

At the government level, the development of SIB programs may be challenging given the expertise required. For example, despite the dedication of \$29M in funding for SIBs, the New Zealand government faced significant delays and challenges, partially attributed to the degree of "commercial financial expertise" (p. 7) required, which had to be developed, and the ongoing need for senior decision maker participation (Treasury and Ministry of Health, 2017). Significant resources have also been expended to cover the cost of the intermediaries (Floyd, 2017, p. 24).<sup>30</sup>

Gustafsson-Wright & et al. (2015) in their survey of SIBs conclude that "the first impact bonds have been time-intensive and costly operations" (p. 35), although they and Loxley both suggest that transactions costs may fall over time as the process becomes standardized and capacity is built. There is some precedent for this in PbR contracting, for example in the UK ALMP programming seeing

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<sup>30</sup> See also examples in Chapter 2.

growth with fewer providers and larger contracts (Finn 2008, p. 9). However, some have argued that SIBs under \$15USM cannot overcome fixed transaction costs associated with the model, and that in general this threshold is not close to being reached (Floyd, 2017, p. 22).<sup>31</sup>

#### e) Assessment of Claim 2

The evidence regarding the ability of SIBs to generate higher quality social programs or better outcomes is inconclusive. SIBs have not been tested against conventional social service delivery methods in a manner which would allow this determination to be made. SIBs are not being evaluated from a value-for-money perspective, a problem with PfS programming more broadly (Morse, 2015, p. 36). A useful counterfactual for future research would be to fund conventional providers directly with an equivalent in incremental resources for enhanced project management and administration that are made available through the SIB model to pay out investor returns and higher transaction costs (Whitfield, 2015, p. 34).<sup>32</sup> SIBs, even if successful on their own terms, may not provide value for money; at a minimum, governments issuing SIBs should be required to justify the scheme over standard procurement mechanisms, as has been recommended for PbR schemes more broadly (Morse, 2015, pp. 6-8), and the criteria for evaluating value for money should be stated at the beginning of a contract (p. 33).

While SIBs may have the potential to produce better outcomes relative to conventional procurement or public delivery, they have higher governance and transaction costs. Their possible advantage over conventional contracting rests on their potential ability to project manage effectively, pursue innovation and adapt. If the argument of private sector superiority in this regard is not conclusive, the burden of proof should fall on SIB proponents, including supportive governments, given the higher financing and transaction costs associated with the model.

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<sup>31</sup> Floyd notes that this is substantially higher than the current size in the UK and there is some evidence in the UK that SIB proposals are getting smaller, based on applications to Commissioning Better Outcomes fund. See also KPMG (2014, p. 20) and Azemati et al. (2013) who suggest SIB projects under \$20 USM are not of sufficient size to overcome set up and administration costs associated with the model, which they note are primarily fixed costs.

<sup>32</sup> Liebman and Feller (2014) note that SIBs help reverse a misallocation of resources within governments who under resource management and evaluation in conventional social service delivery.

Examining past experience with privatization and PbR schemes leads to doubts regarding their ability to generate superior outcomes, particularly in the social service context. For privatization to be successful, competition is required, and this is currently not present for SIBs. In fact, given their long-term consortia structure, SIBs are likely to reduce competition in public social service delivery. Neyland (2018) for example labels SIBs as an “anti-market device” (p.492) that restricts competition relative to standard procurement. PbR schemes generate dysfunctional behavioral responses that require additional resources to mitigate. PbR contracts are also not without downside risk. As captured succinctly by the UK Auditor General “PbR is a technically challenging form of specialist contracting, and poor design and implementation can have a negative impact on the quality of public services and value for money” (Morse, 2015, p. 22). The challenges of PbR schemes has resulted in many cases in a return to conventional contracting, and in some cases in-house provision (Koning & Heinrich, 2013, p. 2). Both privatization and PbR have the potential to displace public-sector motivations of workers and generate large rent seeking and/or windfall gains for investors. The limited evidence to date suggests that these concerns may be relevant in the SIB context.

This section’s review of the effectiveness of PbR initiatives in various sectors suggests ways that SIBs could be structured to reduce the negative impacts. These include: keeping incentive payments relatively low, including front line service providers in the determination of targets; taking time to understanding the motivations of service providers (Heinrich & Marschke, 2010, p. 203); verifying and being explicit regarding the link between performance indicators and the actions of frontline staff (Klitgaard, 1997; Palameta, Myers, & Conte, 2013, p. 41); using incentive payments as a tool to inform and educate service providers regarding the costs and benefit of their actions and impacts; clarity regarding what changes could be made by service providers to lead to improved outcomes and successful incentive payments (Murnane & Cohen, 1986); using incentives where staff are responsible only for the outcome being incentivized (Heinrich & Marschke, 2010, p. 203); revisiting contracts and targets in response to new information and to address unforeseen issues (Morse, 2015,

p. 33); and requiring returns be earmarked for reinvestment in social causes. More generally, for PbR to be successful a broader set of reforms are required, including a participatory process around design, training and evaluation with the associated required investments (Klitgaard, 1997).

The attributes of the SIB model that most convincingly promise improvements include the built-in central coordination within government to break down siloed decision-making between departments to determine the net impact of a social service intervention, and in turn funding initiatives that are expected to produce a social return and potentially a financial return to government. The second is the increased resources provided to improve research, evaluation and performance management. Neither of these attributes require the privatization of finance and management or the PbR structure built into the SIB model, so it is unclear at this stage of the analysis why these changes could not be pursued independently.

### III. Claim 3: Better system:

Proponents not only claim that SIBs are having a positive impact through SIB projects but also through broader changes to social service delivery systems, both within and between government and private partners. Dear et al. (2016), for example, capture this sentiment in the following passage: To fully appreciate the impact of Social Impact Bonds, we need to look beyond program performance data. Clear evidence of broader impact is emerging outside the context of individual projects, including improving the capacity of social and public sector organizations and informing policy through the availability of measured outcomes and performance data. Such impact demonstrates the ripple effect of Social Impact Bonds—builds confidence in the values of specific outcomes for government, service providers, and investors, and in doing so, has an impact that extends far beyond the project’s domain. (p. 31)

This discussion is embedded in the “public sector reform narrative” as part of the New Public Management approach, highlighting the weaknesses of the status quo state and potential for private

sector practices and values to improve the delivery of public services. (Fraser, Tan, Lagarde & Mays, 2018, p. 9). Two focal points for the analysis include the emphasis on outcomes and evaluation in spending decisions, and a better allocation of risk between sectors.

#### a) Focus on Data/Outcomes/Evaluation

Within government itself, proponents highlight how SIBs have ripple effects beyond the individual projects they enable by encouraging and building capacity to generate the data and management systems required to track and ultimately govern based on outcomes. Liebman and Sellman (2013) for example note that SIBs:

“drive change as part of a broader performance agenda... A SIB project may also involve the development of systems for linking data across agencies in order to measure outcomes – systems that can be applied to existing spending as well... a [successful] SIB project could break through the political obstacles and allow not just the incremental SIB spending to be performance-based but also allow for better allocation of base spending – spending that will often be much larger than the incremental SIB spending. These kinds of spill-over benefits to a broader reform agenda could make even a small SIB project worth doing” (p. 15).

Dear et al. (2016) project similar sentiments: “Social Impact Bonds are prompting the development of data systems to help identify the most effective social interventions and to help make optimal public sector resource allocations in the future” (p. 32). They also highlight how SIBs have led to the integration of research and policy on social interventions, leading to the development of “data clearinghouses which serve as a tool for policymakers when making funding decisions” (p. 32) such as the Unit Cost Database referenced in Chapter 1. Finally, they highlight the collaboration required in an SIB necessitates intensive research and evaluation which “Invariably... leads to a more detailed understanding of the issue and the way the current system handles it, providing insight into how such systems could be improved beyond the context of one Social Impact Bond” (p. 35). SIBs then are claimed by proponents to not only drive efficiency within projects through incentive

alignment but also improve allocation of spending across government (Fox & Albertson, 2011), both through and outside of SIB projects.

This is a process that evolves over time and points to the potential of SIBs and PfS to generate a “rigorous feedback loop [...] to correctly allocate government’s abundant social sector resources” (Overholster & Whistler, 2013, p. 5). SIBs, if applied more broadly, may serve a discovery-type purpose with respect to resource allocation within government that generates a positive externality in a dynamic setting with an existing bundle of imperfect social service delivery models and incomplete information regarding the optimal delivery structure. Implemented on a large scale, SIBs may systematically allocate resources more efficiently by helping identify and eliminate wasteful projects and/or delivery models from those that are effective.

SIBs in themselves may or may not be more efficient for a particular project in question, but overall, they may be efficiency-enhancing as a broad application of their governance structure within government overtime could eliminate other wasteful projects whether directly or through the diffusion of outcomes-focused governance.<sup>33</sup> SIBs may have to rely on these externalities to realize the hefty promise celebrated by proponents, as some have pointed out that SIBs cannot be relied upon to provide for “core” government operation given that “failure to achieve performance targets could lead the providers to cease operations” (Liebman & Sellman, 2013, p. 20), limiting opportunities for scale. Given these challenges, some see SIBs as merely a transitional device towards more extensive outcome-based commissioning or payment by results, since these avoid the need to pay for an additional intermediary with the associated transactions costs (Jagelewski, 2016). However, others doubt whether new institutions will provide loan finance of this kind, and the risk of current developments in commissioning - such as the promotion of prime contractors which are

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<sup>33</sup> Dear et al (2016, p. 81) highlight the potential that SIBs in the end can facilitate a conversion to greater outcomes-based procurement by government without private finance, but see a role for both on an ongoing basis.

then left with the task of organizing supply chains and partnerships - is that these tend to leave the voluntary sector in a weak position, and with low margins. (Mulgan, et al., p. 14).

## b) Risk Transfer

A second claim that has been made regarding the potential of SIBs to generate a more effective social service system is through better allocation of financial risk between government and the private sector. Several proponents have made the claim that the PbR mechanism is a positive attribute because of the transference of the risk of failure away from government to the private sector (Dear et al., 2016, p. 17, Deloitte, 2012, p. 3; Fraser, Tan, Lagarde & Mays, 2018, p. 10, Office for Social Innovation and Civic Participation, 2016; Mulgan et al., 2011, p. 16). This argument is similar to one prevalent in the case made for PPPs in infrastructure.<sup>34</sup>

To analyze this proposition, one must first define 'risk' as well as the perspective from which one is asking the question. There are at least two relevant definitions of risk when analyzing SIBs. The first is a statistical or economic definition of risk, where risk refers to the variance or uncertainty with respect to the predicted value of an event. If one assumes 'rational' expectations, all information available is used when predicting the expected value, and such a prediction would be unbiased and equal to the average the outcome would converge to if able to be repeated over and over again in an identical context. If the person or institution evaluating the event is risk neutral, they are indifferent to the uncertainty or variance, they only care about the expected value of the outcome. If individuals are risk adverse, they are willing to trade off some of the expected value for greater certainty of achieving it.

Traditionally in economic analysis, the state is assumed to be risk neutral given its ability to full self-insure against risk given its powers to raise revenues through taxation. If one is evaluating SIBs from the perspective of a benevolent public-sector manager who implements public policy based on broader social welfare considerations, the idea that risk transfer alone can justify SIBs use is

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<sup>34</sup> This parallel is explored in more detail in Chapter 4.



erroneous (Liebman & Feller, 2014). On the other hand, if one considers the motivations of politicians and assume that they may be more sensitive to a failed project than a successful one, then SIBs may be a tool for circumventing this risk aversion.<sup>35</sup> This assumes investors are more willing to accept risk, which is not self-evident.

Risk can be viewed narrowly as statistical random variation in the outcomes of program participants. However, risk can also be understood more broadly to include treatment integrity such that prescribed methods are delivered in accordance with an established model, as well as other logistical and quality risks that come along with the implementation of any complex service delivery that requires the coordination of multiple actors (Dear et al., 2016, p. 17). One argument that could be made is that the private sector consortium under an SIB can be better placed to manage these additional 'risks' given the inclusion in the consortium of front line service providers and foundations who have better information on and control over the quality of front line service being delivered than the government procurer, again within the "street-level bureaucrat" paradigm (Heinrich, 2011, p. 231; Lipsky, 2010). The potential welfare gain here is not from transfer of risk to a less risk-averse agent, but a better alignment of incentives where those with information and control over 'what works' are induced to exert effort to deliver a higher quality service.<sup>36</sup>

This claim of broader system wide benefit of the transfer of responsibility is subject to all the complications and caveats noted above regarding PFS and privatization schemes. A fulsome risk analysis would also account for other dysfunctional behavioral responses of service providers and contingencies such as service providers prematurely terminating the contract, either voluntarily or otherwise, leaving clients without service provision and by default reverting to other government or non-profit systems (Gustafson et al., 2015, p. 40). Also, depending on how broadly one defines risk, the degree to which transfer is beneficial will depend on the extent that transaction costs are

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<sup>35</sup> This is implied by Toby Eccles, the founder of Social Finance, who states that "Social Impact Bonds provide politicians with a route to encouraging public servants into trying something new" (Dear et al, 2016, p. 17).

<sup>36</sup> This argument is central to the case in several economic analyses of PPPs for the superiority of the PPP model over conventional infrastructure procurement. See Bennett and Iossa (2006), Hart (2003), Iossa and Martimort (2015) and Martimort and Pouyet (2008).

incorporated into the analysis (Fraser, Tan, Lagarde & Mays, 2018, p. 13). Finally, the above discussion of risk equates bearing of risk with allocating responsibility for final funding of projects, given the normative and often legal obligations of government to address social problems, “operational and reputational risks associated with failure” will always at least partially remain with government, further undermining risk transfer in practice (Fraser, Tan, Lagarde & Mays, 2018, p. 15; Giantris & Piakiewicz, 2013). Within a broader conception of risk, the threat to proper governance and accountability all raise challenge in public-private partnership structures (Hodge, 2004), such as SIBs.

### c) Assessment of Claim III

SIB proponents argue that SIBs will benefit the entire social service system, primarily by demonstrating success and focusing government practice on evaluation and outcomes more broadly as well as through a more efficient allocation of risk. These claims are difficult to substantiate. While there is evidence to support that capacity is being built within organizations to better track outcomes, and government organizations are clearly assembling support for SIB and PfS projects, the degree to which this is influencing and shifting the broader social service system is unclear (Gustafsson et al., 2015, p. 46) and will require further research through case study.

The UK is the most likely location that these changes would be occurring, given its leading role in piloting the first SIB and its current position as the leader in number of SIB contracts issued (Social Finance, 2018). But, as the UK auditor general notes “neither the Cabinet Office nor HM Treasury currently monitors how PbR is operating across government. Nor is there a systematic collection or evaluation of information about how effectively PbR is working” (p. 8). This does not bode well for any broad systematic knowledge dissemination stemming from SIBs. It is also unclear if government is accumulating this knowledge or if it being captured by the private sector intermediaries (Floyd, 2017, p. 24).

Even with respect to individual projects, there is the danger that SIBs may be overreaching on their ability to drive rigorous research on the effectiveness of policy interventions. While the establishment of impact through the utilization of control groups is profiled as the ideal, in practice this has not been a pervasive practice (Carter et al., 2018). Morse (2015), the UK auditor general, highlights the importance of this in PbR schemes for effective identification of impact, but “To date, only a few schemes have monitored performance against a counterfactual” (p. 8). Fraser, Tan, Lagarde & Mays, (2018) also note that the inability to establish appropriate control groups has been a challenge in the UK and US SIBs. Not only are there technical challenges but coming to terms between the contracting parties over ‘the facts’ is not as straight forward as it may initially appear (Maier & Meyer, 2017, p. 3). Recent case studies have also demonstrated that in practice few projects are hitting the high evaluations standards claimed central to the SIB model (Carter et al., 2018; Heinrich & Kabourek, 2018).

Even if SIBs were meeting the ideal of a fully randomized control trial for each SIB project with metrics embraced by all contracting parties, the SIB model rests on the equivalent of a 100% program audit rate, which is unlikely to be efficient, even in a standard economic model of self-interested agents with diminishing returns. A reallocation of resources away from monitoring to incremental service delivery, with remaining service provider monitoring and accountability being partially based on an adherence to a proven program model, would likely be more efficient. This is arguably what the conventional procurement model in practice aims to do, with quality performance reinforced by the prospect for contingent renewal of contracts. As noted in chapter 1, there are many problems with relying on RCTs, including both technical and ethical issues. Alternative evaluation forms more appropriate to social service delivery for vulnerable populations are available, “but they do not yield clear financial metrics for private investors” (Tse & Warner, 2018b, p.10).

With respect to risk transfer, a proxy for the degree of actual risk transfer is the degree to which projects are failing to meet their targets and investors not recouping their investment (Gustafson et

al., 2015, p. 40). With the exception of the high-profile failure of the Riker's Island project, SIBs appear to be meeting their targets and governments in the vast majority of cases are paying out the bonds and investors.<sup>37</sup> Even if risk was being transferred in practice, there isn't a strong case from a social welfare perspective for transferring risk to the private sector. A private sector partner will need to be compensated for accepting risk (Maier & Meyer, 2017, p. 6). For risk transfer to make sense, it needs to be seen as a response to political risk aversion, but this case for risk transfer raises the question of to what degree should one accept and cater to the political motivations of elected officials, as opposed to better holding politicians to account for implementing objective and evidence-based improvements in public policy.

While the external benefits of SIBs are plausible, the case being made for broader systems change ignores much of their negative potential impact. First, a greater reliance on the wholesale outsourcing model on which SIBs and PfP are based runs the risk of deskilling the public sector and placing government at a disadvantage when procuring social services. As Finn (2008) puts it: "When service delivery is devolved to independent providers, the purchaser loses insight into the 'why' of 'what works'. Contractors and their front-line staff inevitably gain an advantage as they develop greater operational knowledge of how to achieve specified outcomes" (p. 7) and are more likely to keep this information private to gain a competitive advantage. He notes however this can be partially offset through administrative measures to supervise, evaluate and share information (p. 7). While this diffusion is already partially taking place through conventional procurement relative to direct public service delivery, it is amplified under the contracting out of management implicit in SIBs. Additionally, if SIBs are replacing unionized, public service workers with lower paid private sector consortiums and more precarious employment, SIBs may have unintended consequences with respect to income inequality and working conditions in the social service delivery sector.

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<sup>37</sup> See Chapter 2.

Secondly, as the system achieves scale and the market for SIBs grows, and SIBs become less relationship-based, some gains from scale, standardization and competition may emerge, but this is at the risk of greater displacement of public service motivation and a greater likelihood of rent-seeking behavior. A cautionary example is provided by the evolution of US prison labor and privatization leading to what has been termed the *prison industrial complex*. Initially motivated by the desire to provide training opportunities for inmates, undertaken directly and tightly regulated by the state, the use of prison labor expanded rapidly in response to lobbying efforts by large corporations who advocated for deregulation of the use of prison labor, including minimum wage requirements, and removing restrictions on the market for prison labor produced goods (Thompson, 2012, pp. 40-41). After the removal of these restrictions on prison labor, these companies turned their efforts to “lobbying for and passing harsher sentencing for non-violent offenses including three-strike laws, mandatory sentencing, and truth-in-sentencing”, expending over \$32 Million dollars between 2000 and 2010 on lobbying activities and campaign contributions (Thompson, 2012, pp. 40-41). The initial opening of prison operations to private for-profit actors in an attempt to make a program more efficient led to an entrenched set of vested interests, rent seeking and state capture activity that was unlikely to be predicted at the time. While this may be an extreme example, it highlights the potential for unanticipated consequences when previously sheltered public-sector activity is opened up to for-profit opportunities for the private sector.

Thirdly, shifting the responsibility to achieve outcomes to private sector partners may weaken the ability for the public to hold government to account. Private contractors are often not subject to the same disclosure requirements of public bodies and its governing legislation and independent offices, creating “considerable scope for ‘blame shifting’, with the responsibility for poor performance is less obvious”(Finn, 2008, p. 8). Finally, the shift to greater reliance on the private sector ignores the interdependencies of social challenges and the unique position of the state to coordinate strategic responses, as outlined above in the discussion of innovation.

Despite these challenges, there is some evidence that SIBs can be successful in building support for effective social programs, particularly in more conservative political environments, where public funding support is was previously absent. Tse and Warner (2018b) for example highlight how two US early childhood PFS interventions, supported by a strong network of community stakeholders, were able to leverage longer term public funding commitments from government to sustain the intervention subsequent to the SIB demonstrating results. They emphasize however the second-best nature of this result given the well-established evidence regarding early childhood interventions and high transaction and financing costs associated with SIBs relative to conventional delivery, and point to a counter example where this did not occur, with investors benefiting at the expense of programming for vulnerable families.

## IV. Conclusion

This chapter reviewed our interpretation of the three central proponent claims with respect to the benefit of SIBs, including: the ability to generate incremental new resources for cost-effective preventative social programs; the ability to deliver more efficient or higher quality programs; and the systematic benefits SIBs generate for the larger social service delivery system. The evidence on SIBs generating new funding for initiatives is inconclusive. Private capital is coming forward to finance SIB projects, but this must be repaid by government if the project is successful. SIBs for the most part are meeting targets and being paid out, so the private sector generally is not paying for new programs, only financing them at a rate of return on average greater than government borrowing rates. This project finance in theory could allow incremental new projects to proceed by skirting self-imposed government budget constraints, if the social interventions are netting cashable fiscal savings to government such that the interventions end up paying for themselves. In practice however, many governments are setting aside current funds for SIB payments, requiring incremental

or reallocated public funding that could otherwise be available for direct financing of prevention-focused social programs.

Similarly, the direct evidence to support claims of increased social program quality or efficiency under SIB delivery is inconclusive at this stage. Part of this is due to the relative newcomer status of the SIB model, but this is also due to the apparent indifference of those involved to determine its relative merits vis-à-vis other procurement methods. To date there have been no controlled experiments to test whether SIBs provide superior outcomes compared to conventional procurement or public delivery. The quality or efficiency enhancing potential of SIBs to improve projects delivered through the model rest on implicit and explicit assertions that privatization leads to better project management and facilitates innovation, and that the SIB model improves incentives through the PbR payment structure and also better coordination within government and broader stakeholder participation. Theoretically these claims are weak, particularly in the social service context, where contracting out has shown to have minimal efficiency gains, and financial incentives have generated dysfunctional behavioral responses. The most intuitively beneficial attributes of the SIB model, government prioritization of cost effective prevention programming and the better alignment of activity across departments, rest on state-led reforms within the public sector itself, based on central government planning that appears to be independent of the procurement model used to deliver programs.

With regard to the ability of SIBs to have beneficial external effects on social service delivery more broadly, it is simply too early to tell whether experience with the model is leading to positive changes with respect to a focus on outcomes and evaluation or potential negative impacts arising from dysfunctional responses by service providers and questionable practices associated with the introduction of new rent seeking opportunities. As the scale of SIB utilization increases, it is likely that more data will emerge, however experience with previous privatization and PbR initiatives

highlight the potential for both efficiency gains and detrimental effects, both with respect to quality and long run value-for-money.

Despite their questionable foundation, SIBs appear to be attracting additional public funds and may be permitting in the short-term incremental preventive social service delivery to proceed by overcoming self-imposed fiscal restraints. Governments appear to be paying for the cost of SIB delivery, including the new administrative structures required and the return to investors. Significant support, both in-kind and financial, is being committed to the SIB model, with an associated opportunity cost. Governments could alternatively be investing these resources in improving public-sector service delivery directly.

SIBs are being deemed a success by proponents because they are meeting their targets. This result however is unsurprising since the model is primarily replicating and/or scaling-up proven interventions, with built-in additional supports for evaluation and management capacity not available under other models. If we are truly to compare this to an appropriate counterfactual, existing non-profit service provision models will need to be equally resourced and studied under similar circumstances.



# Chapter 4: MODELLING SOCIAL IMPACT BONDS AS PUBLIC PRIVATE PARTNERSHIPS

## Introduction

This chapter assembles a conventional economic model for evaluating the potential of SIBs as a means to make the delivery of publicly funded social services more efficient. Building on the work of existing economic analyses of the SIB model (Pauly and Swanson, 2017; Wong, Ortmann, Motta & Le Zhang, 2016), we draw upon literature examining Public Private Partnership (PPP) models of infrastructure procurement and delivery, using the incentive theory approach to the economic analysis of contracts.<sup>1</sup> SIBs and PPPs share many features relative to more conventional public-sector procurement models (Gustafsson-Wright et al., 2015; Loxley, 2013; Tse and Warner 2018a; Warner 2013; Warner 2015). These include the bundling of design, financing and operating activities, an increased role for the private sector in project planning and delivery, and a transfer of responsibility and associated risk from the public to the private sector. They also both involve the raising of financial capital for public projects through private consortia as opposed to conventional public borrowing methods. Recognizing SIBs as a variation on the PPP concept allows for the application of theoretical modelling approaches from the PPP literature, which we argue can help fill gaps in the existing work on SIBs.<sup>2</sup>

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<sup>1</sup> PPPs are also known as Private Financing Initiatives (PFIs) in the United Kingdom when private financing is part of the bundled procurement contract.

<sup>2</sup> Formal analytical approaches to modeling PPPs include Bennet & Iossa (2006); Bentz, Grout & Halonen (2005); Engel, Fischer & Galetovic (2013), Grout & Sonderegger (2006), Hart (2003), Martimort & Pouyet (2008), Maskin & Tirole (2008), and Menezes & Ryan (2012).

In this context, the potential of the SIB model to deliver superior outcomes is its ability to better address incentive and agency issues in SIBs (McHugh et al., 2013; Stid, 2013; Maier & Meyer, 2017; Pauly & Swanson, 2017; Pandey, Cordes, Pandey, & Winfrey, 2018; Wong et al., 2016). Pauly and Swanson's (2017) analysis focuses on how an SIB can be superior to standard PbR contracts based on conventional combinations of borrowing and donation based finance when the SIB enables financiers to contribute effort to program improvement. In their model, potential financiers include market-based lenders, altruistic donors, and altruistic lenders willing to accept a reduced rate of return. If financiers do not contribute such effort, there will be an equivalence between financing models, where "SIBs provide no advantage over alternative organizational structures" (p. 721). In Pauly and Swanson's model, an altruistic investor exerts greater effort than a traditional donor, given their fact that their investment is at risk in addition to their donation (in the form of a reduced rate of return). The SIB allows socially beneficial projects to proceed that would not be feasible based on conventional PbR funding arrangements. Wong et al.'s (2016) model also relies on induced effort through the contracting structure, but the effort is generated by the non-profit provider who is now supervised by investors. The outcome however is similar, in that due to the financial incentives facing the investor (and the assumption that investors have an incentive and ability to increase program quality that government lacks) the SIB contract generates superior outcomes.

PPP models in the incentive or contract theory approach parallel the above SIB models in that they emphasize how a contract structure that incentivizes greater uncontactable effort levels can generate more efficient outcomes. While the above SIB models rely on a transfer of greater outcome risk and in turn potential financial loss to private partners to motivate effort, PPP models suggest an additional source of efficiency. In these models, PPPs can be more efficient due to the bundling of contract components, which generate a more optimal level of upfront investment in design and/or

capital asset quality.<sup>3</sup> For example, in the case of road construction, under a PPP it is likely that a more durable road will be built with lower long run maintenance costs, minimizing total present value costs over the lifespan of the road. This is due to a single firm being responsible for both construction and maintenance costs, with the company only harming itself by skimping on quality (and that under a PPP the firm often is obliged to return the asset to the public sector in 'as new' condition).<sup>4</sup>

This PPP modeling approach, as a multi-task principle agent problem, helps clarify the sources of potential welfare gains under SIBs, pointing to positive bundling externalities and better resolution of principal-agent problems, in addition to outcomes based payment. Take for example a social program aimed at safely reunifying children apprehended by child welfare authorities with their parents. Under an SIB, where design and operations are bundled, PPP models would suggest that this bundling would likely lead to a more optimal amount of research and development in an effective intervention that helps families succeed in providing a safe home environment for the children. This is due to designers and financiers, now part of a consortium of firms, having a stake in operational effectiveness (both because returns to the consortium are based on outcomes and government compensation is not based on realized costs). Our model incorporates both risk transfer through compensation-based on outcomes and bundling externalities as potential sources of SIB efficiency.

The above models however neglect the potential negative impacts of the SIB structure. In the PPP literature, it has been noted that these delegated contract structures can lead to contractors engaging in service quality reductions while staying within the letter of the contract, and that this should be explicitly considered (Hart, 2003). This is one of the downsides of the residual claimant status in PPPs and SIBs in a context of incomplete contracts. Examples in the PPP infrastructure case

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<sup>3</sup> Representative samples of PPP models include Bennett and Iossa (2006), Hart (2003), Iossa and Martimort (2015) and Martimort and Pouyet (2008). For a more general discussion of incentive theory see Laffont and Martimort (2002).

<sup>4</sup> Since payment is predetermined as long as contractual obligations are met, the private sector's status as residual claimant also provides incentive to achieve this optimum quality at minimum cost, as all savings generate financial returns for the private sector partners. An SIB also provides a similar residual claimant incentive to reduce costs, as payment is based on outcomes and the SIB consortia retains any cost reductions based on more efficient service provision due to, for example, a greater emphasis on performance management.

include denial of public access and lax staff background checks in PPP schools, and sewage spills and health and safety violations in PPP water treatment facilities (CCPA SK, 2015). In the SIB case there have been multiple allegations that SIB projects have engaged in selecting clients that would most easily meet threshold targets, as opposed to those who would most benefit from the programming (Edmiston & Nicholls, 2018; Loxley, 2017; Tse & Warner, 2018a). Unlike previous SIB models, our model explicitly accounts for such negative effects.

The above insights are helpful for understanding the case made for partial privatization models such as SIBs as well as some challenges, but still neglect some important features of the debate over the efficacy of SIBs. We also introduce theoretically supported and empirically informed differences in transaction costs and variations in the degree of supplier competition, when selecting an SIB over a competing delivery model. This explicitly brings to the fore some additional considerations driving cost differentials between the two models. We then examine the form taken in practice within SIB contracts for investor compensation and examine the claim by proponents that SIBs are necessarily superior given their Pay-by Results (PbR) structure.

This chapter complements the work of analysts, in addition to Pauly and Swanson (2017) and Wong et al. (2016), utilizing economic methods who have emphasized how SIBs can be welfare-enhancing by helping resolve agency issues or by helping to internalize externalities. Liebman and Feller (2014), for example, emphasize the internalization of externalities, with SIBs helping to overcome the lacking incentives of any one particular government to invest in evaluation and produce social innovation, given their limited ability to capture the benefits, relative to the costs. Pandey et al. (2018) also highlight the usefulness of contract theory, as well as transaction cost and property rights approaches when analyzing SIBs. More generally this structure may contribute towards cost-benefit analyses of the advantages and disadvantages of the SIB model relative to conventional procurement. As previously noted, “there has been very little rigorous counterfactual comparison of SIBs versus alternative methods of finance to deliver the same service to the same

type of users, and thus a lack of evidence of costs and benefits compared with the alternative approach to procurement” (Fraser, Tan, Lagarde & Mays, 2018, p. 16; Carter et al., 2018). Stakeholders, such as the UK Auditor General, have also called for more robust and consistent examinations of SIBs and other PbR projects relative more conventional methods given the challenges and limitations of PbR and SIBs (Morse, 2015).

This chapter proceeds as follows: Section I reviews the attributes of the PPP infrastructure delivery model and introduces the suggested benefits of PPPs relative to the conventional infrastructure procurement model. Section II outlines the case for considering SIBs as a type of PPP. Section III briefly summarizes perspectives on privatization in the mainstream economics literature, setting the stage for our economic model of SIBs. Section IV presents an economic model of SIBs based on a linear compensation structure. Section V provides some empirical descriptions of SIB investor compensation structure in practice and explores the implications of non-linear compensation schemes. Section VI concludes.

## I. Review of the Public Private Partnership (PPP) Infrastructure Delivery Model

The phrase *public private partnerships* in general has been utilized to encompass a large variety of relations between governments and the private sector (Hodge & Greve, 2005), but in the physical public infrastructure context, it has a more specific meaning. Under the PPP infrastructure delivery model infrastructure design and construction are bundled, often with financing, maintenance and/or operations, into a single long-term contract with a private sector partner, which is generally a consortium of individual companies. The private sector partner then may maintain control and ownership of the infrastructure asset over an extended contract, at the end of which the asset is transferred back to the public sector. Governments worldwide, facing fiscal constraints, with growing

challenges maintaining existing infrastructure and meeting new demands, have increasingly turned to PPPs for infrastructure delivery for a variety of infrastructure types, including roads, schools and hospitals (Iossa & Martimort, 2015; Loxley, 2010), and later expanded the procurement model to other areas such as information technology and military procurement (Parker & Hartley, 2003; Kuan, 2009). The scope of such operations has reached significant aggregate levels, with total asset investment, as of 2010, of at least of 2.7 Trillion USD worldwide.<sup>5</sup>

PPP contracts are primarily defined by the bundling of investment and service delivery components, and are also characterized by: their long-term nature; the temporary transfer of assets; and the associated risk, including demand risk in the presence of user fees, that is claimed to be transferred from the public to the private sector, arising from greater contractual obligations (Bennet & Iossa, 2006; Bentz, Grout & Halonen, 2005; Engel, Fischer, & Galetovic, 2013; Iossa & Martimort, 2015; Martimort & Pouyet, 2008). This is differentiated from the stylized conventional public procurement model where design and provision is unbundled, with various components being delivered through separate contractors, coordinated and managed by the public sector, or directly by the public-sector entity who retains ownership and control over assets. Bundling under a PPP therefore, at a minimum, transfers some coordination activity from government to the private sector. Financing, when transferred under a PPP, also devolves activity traditionally undertaken by government to the private sector. A PPP may also transfer activity for design, operations and maintenance which was previously done by public sector staff outside of government. A PPP therefore is an intermediate delivery model between pure public and private provision of publicly funded infrastructure, one that results in incremental privatization over and above conventional contracting out models.<sup>6</sup> This transfer of responsibility and the associated risk transfer are used to

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<sup>5</sup> Calculated by author based on data in Iossa and Martimort (2015) and the Private Participation in Infrastructure Database (World Bank, 2017).

<sup>6</sup> From a delivery standpoint, PPPs can appear similar to privatization, particularly as design, maintenance, financing and operations are transferred to the private sector partner. In other respects, PPPs maintain some attributes of public delivery. For example, asset ownership, if initially transferred to the private sector, is transferred at the end of the contract back to government, and the degree of

justify a number of contract provisions to realize projected profit projections upon which private investment in the project is based, including in some cases the granting of service monopolies in addition to government lease payment commitments (Istrate & Puentes, 2011; Warner, 2013).

### a) Sources of Efficiency Enhancement under the PPP model

Several sources of efficiency have been put forward to rationalize the PPP model. In economic models of PPPs, the primary emphasis has been on how the bundling of all components of project delivery imposes a life-cycle cost perspective on the private sector participants and therefore can result in a more efficient cost and risk allocation in an asymmetric information environment, due to economies of scope (Iossa & Martimort, 2015; Hart, 2003; Martimort & Pouyet, 2008).<sup>7</sup> It has also been argued that the PPP model has the potential to prevent sub-optimal high-cost projects from proceeding by being passed off by insiders as projects with low or uncertain costs, and can reduce the ability to cater to special interests rising from the preference of public servants based on ideology or relationships with contractors (Maskin & Tirole, 2008).<sup>8</sup>

User fees associated with PPPs have also been identified as the source of efficiency enhancements. They have been claimed to permit a more optimal allocation of demand risk (Engel, Fisher & Galetovic, 2013). PPPs can also generate efficiencies in the presence of user fees if one assumes that flowing money otherwise through government into subsidies imposes additional costs (Engel et al., 2013). PPP rationalization resting on the benefits of user fees require the assumption that the user fees were not feasible or sustainable under conventional procurement model with

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retained risk held by the public sector is high. In practice PPP contract structures have resulted in the public-sector partners carrying substantial retained risk both initially, and through subsequent contract revisions and outcomes (Loxley, 2010). It has also been argued that from an a priori perspective the optimal risk profile of a PPP is more similar to that of public infrastructure provision (Engel et al., 2013). Some have argued in fact that the PPP terminology and framing is a guise to soften resistance to contracting out and privatization (Hodge & Greve, 2005, p. 7).

<sup>7</sup> Martimort & Pouyet (2008) highlight two distinct issues with respect to the potential gains from bundling and ownership transfer. If contracts are complete and exclusively performance based, ownership is irrelevant, and the tasks should be bundled if increased asset quality generates a positive operations externality and unbundled if the externality generated is negative. In the case of incomplete contracts and asymmetric information regarding quality, transfer of ownership to the concessionaire may support increasing asset quality to the socially optimal level. This point links back to the insights of Hart (2003), discussed further in Section Four.

<sup>8</sup> SIBs have also been put forward as a means to address political-economic problems around government not allocating resources in an efficient manner by Public Choice orientated scholars (Liebman & Feller, 2014; Wong et al., 2016).

public asset ownership, for example, due to the inability of politicians to resist popular opposition to such fees.

## b) Efficiencies in the Conventional model

While the efficiency-enhancing potential of the PPP structure is emphasized in economic models of PPPs, there are also potential benefits and efficiencies available through the conventional delivery method. These may arise when the assumptions of complete and fully enforceable contracts, perfectly competitive supplier markets, zero transaction costs, or hyper-rational self-seeking stakeholder motivations are violated, or there exist additional information asymmetries beyond effort-fueled investments in quality.

These potential benefits and efficiencies include: the ability to better target construction and operations contracts to specialized contractors through unbundled contracts (Maskin & Tirole, 2008; Laffont & Tirole, 1988); reducing the size of the payoffs from collusion between the state and contractors, and therefore reducing the incentive to participate in contracts that are socially sub-optimal (Martimort & Pouyet, 2008); and by providing more flexibility to future governments who may find themselves bound to sub-optimal contracts (Laffont & Tirole, 1993, pp. 619-636). PPPs can also result in sub-optimal levels of service quality where contracts are imperfectly enforceable (Hart, 2003; Bentz, Grout, & Halonen, 2002; Bennet & Iossa, 2006; Martimort & Pouyet, 2008). In the case of essential services, the supplier will have increased bargaining power in terms of service delivery, such that they can threaten to disrupt delivery of these services. This effectively reduces risk transfer from government and increases the likelihood of renegotiation in favor of the concessionaire (Grout & Sonderegger, 2006), particularly in the presence of an underperforming revenue stream and a credible threat of private partner default (Menezes & Ryan, 2012). Alternatively, one of the main benefits of a conventional government procurement contract is that it is based on a contingent renewal basis, such as the one based on the notion of contested exchange as presented by Bowles and Gintis (1993), and modelled in Bowles (2004, pp. 233-266), where the repeated interaction and



the associated relationships developed generates efficiencies. Finally, publicly delivered services may also benefit from additional uncompensated labor time or effort stemming from a public service ethic (Glaeser & Shleifer, 2001; François, 2000), particularly in sectors such as health and education (Grout & Sonderegger, 2006), which would be forgone to the extent in which PPPs incrementally privatize delivery.

### c) A Note on Private Financing of PPPs

While bundling efficiencies are currently the main rationale put forward for PPPs, the rise of the PPP model was initially supported by a more practical and direct advantage for governments, or more specifically, politicians. Initially, PPPs allowed public sector entities to generate new infrastructure construction without creating a liability on the government balance sheet, which provided a political incentive to utilize the model as a means to skirt formal and implicit budget constraints based on accounting conventions. This 'off-book' accounting of PPPs has been extensive, with, for example, the UK Government holding approximately 87 percent of its £40 Billion PPP portfolio off-books as of March 2010, such that it was not included in official figures for public sector net debt (Office for Budget Responsibility, 2011, p. 42; Hodges & Mellet, 2012).

The accounting benefit of PPPs was a key component of arguments in both the UK and Canada for adopting the PPP delivery framework, but increased attention of auditors and the application of accounting conventions such as the International Financial Reporting System (IFRS) has resulted in the recognition of PPPs as capital leases as opposed to operating leases. Many PPP arrangements now must be accounted for as part of public sector debt, leading to a shifting emphasis by proponents to value-for-money considerations (Broadbent & Laughlin, 2005; Coulson, 2008; HM Treasury, 2012; Hodges & Mellet, 2012; Loxley, 2010, pp. 28-33).<sup>9</sup>

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<sup>9</sup> There is also evidence that a more regimented financial oversight leads to greater public borrowing and lower debt costs. For example, see Baber and Gore (2008) who find that municipalities that use GAAP accounting principles have higher public borrowing amounts and lower debt costs.

These changes in accounting treatment were based on the fact that PPPs do not generate new incremental resources for infrastructure purely from their financing structure in any 'real' i.e. non-accounting sense, such that the government ends up generating new infrastructure without having to finance it either directly or through a revenue stream concession. PPPs financed fully by a combination of upfront and ongoing transfers generate a fiscal obligation held by government, similar to standard debt-financed capital projects. Whether the transaction is 'on-books' and accounted for as a capital lease, or 'off-books' and accounted for as an operating lease, PPPs have an equivalent effect on the real government budget constraint as conventional procurement, regardless of accounting treatment (Engel et al., 2013; Loxley, 2010, p. 30; Vining & Boardman, 2008). In the case of user fees, government concedes access to a revenue stream that could otherwise be used as an alternative to discretionary taxation, so there is no new net generation of fiscal capacity (Engel et al., 2013). Only in the case of credit constraints such that governments were restricted in their ability to raise public financing for projects, an exceptional circumstance for modern developed economies, could PPPs be deemed as a mechanism for allowing projects to go forward that otherwise would not have been possible. Given this and that the risk structure of PPPs is much closer to conventional procurement and that there are ongoing implications for the public budget, it has been argued that PPPs should be accounted for as government liabilities in a manner similar to conventional infrastructure projects (Engel et al., 2013).

While private finance does not create the windfall of resources originally proclaimed by early PPP proponents, private financing may theoretically still be a source of efficiency improvements. These efficiencies may arise from the type of bundling externalities already noted, for example, due to informational advantages possessed by private financiers regarding design or asset quality and maintenance that can be extracted by government through bundled contracts (Iossa & Martimort, 2015). Secondly, private financing may have a lower cost in the presence of user fees, if government administration costs and the deadweight loss and distortionary impact associated with taxation are

high (Engel et al., 2013), although this relies on the assumption that the applications of user fees are tied to private finance. Regardless, these arguments are clearly distinct from the notion that PPPs generate infrastructure without government having to pay for it. In general, in advanced capitalist societies governments generally face lower direct borrowing costs, and if one ignores user fees, which are not present in the SIB model, the higher cost of private finance must be offset by efficiencies elsewhere if the model is to produce net benefits.

## II. SIBs as Public Private Partnerships

SIBs have many attributes in common with the Public Private Partnership (PPP) model of public infrastructure delivery (Gustafsson-Wright, et al., 2015; Loxley, 2013; Loxley & Puzyreva, 2015; Warner, 2015; Whitfield, 2015, p. 22; Tse and Warner, 2018a). Both models involve the bundling of private upfront investment and financing with design and ongoing service provision in a single contract, although the expenses would be more front-end loaded in a PPP relative to an SIB, given its high capital intensity. Agency problems involved in social service delivery contracts are central in SIBs (Maier & Meyer, 2017; Pauly & Swanson, 2017) and similar to those in infrastructure-based projects. Governments may face challenges in identifying the quality of the upfront investments in design and set-up of the project. Where these investments reduce service delivery costs, governments may induce a more optimal effort level from contractors in enhancing quality by combining initial development with ongoing service delivery into a single contract. Similarly, private financiers may have access to unique information and/or abilities that government might only access by enlisting their capital to finance the project (Pauly & Swanson, 2017). If one interprets the set-up and design elements of a social service intervention as the 'infrastructure' used to deliver the social service intervention, then PPP models can be applied to SIBs with some adaptation.

SIBs face potential drawbacks associated with bundling related to loss of government discretion and flexibility analogous to those relevant in the PPP decision-making context. Stakeholders are

faced with similar incentive structures due to compensation not being tied to realized costs. SIBs also require large upfront investment in the development of the program intervention, primarily for research and development, and the establishment of the project consortium. They similarly require the development of complex legal and administrative structures, leading to higher costs in these areas, as in the PPP case. SIBs and PPPs have also both been characterized by a need to subsidize or otherwise guarantee a portion of the returns to secure private partner participation in the face of the high risk associated with the transfer of obligations and responsibility (Warner, 2013). Given all of the above, the task of a public sector decision maker seeking the socially optimal delivery method is similar for SIBs to that identified for PPPs: to determine if the net expected benefit of bundling, assuming it is positive, is sufficient to offset the expected higher transaction costs of and loss of discretion over service provision over the course of the contract (Coulson, 2008; Vining, Boardman & Poschmann, 2005).<sup>10</sup>

SIBs, similar to PPPs in their early phases of adoption, are also being claimed to have the benefit of generating new funding resources for undertaking desired government initiatives, without adding to public debt.<sup>11</sup> This off-books benefit is facilitated by the particular accounting treatment of SIB contracts whereby government does not need to have the associated liabilities reflected in government accounts, and does not address the fact that the government has incurred an obligation to pay out the contract at a later date. In this case SIBs may be utilized to shift expenditures off-books, as previously was the case for PPPs.

While there are many similarities, SIBs are also distinct from PPPs in some important ways. First, SIBs rely heavily on philanthropic considerations, with investment sourced from both for-profit and non-profit charitable sources, and non-profit service providers playing a major role in service delivery. The few economic models of SIBs to date have highlighted how the combination of

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<sup>10</sup> While there are significant similarities between PPPs and SIBs, some key differences do exist including: the tenure of contracts, with PPPs last decades compared to years in the SIB case; and the lack of user fees in the SIB case, leading to no direct consumer input into the model, with incentive discipline being fully reliant on outcome assessment by the independent evaluator (Warner, 2013).

<sup>11</sup> See Chapter three, Section I.b, for further discussion of this point.

charitably motivated contributions and more typical finance and how investors can be motivated by non-pecuniary considerations based on Corporate Social Responsibility (CSR) concerns (Liebman & Feller, 2014; Pauly & Swanson, 2017), or have referenced their potential relevance (Wong et al., 2016). SIBs are also constructed around a PbR model of payment, which is not central to the PPP model. Some of these differences are however a matter of degree, with PPPs operating in social services fields such as healthcare and education where there is also philanthropic investment, and PPPs based on user fees having PbR-like characteristics. SIBs also operate under shorter time frames and operates in core government service sectors including health, education and labor market training where private for-profit participation has historically been more limited, compared to infrastructure delivery which has long been contracted to for-profit builders (Whitfield, 2015, p. 22).

### III. Economic Theory and Modeling of PPPs and SIBs

This section reviews the fundamental theoretical infrastructure behind our model, on principal-agent approaches with asymmetric information in an incomplete contracting setting, as well as justification for including transaction costs, market power, and a CSR effect in our model of SIBs.

#### a) Asymmetric Information versus Incomplete Contracts

The economic analysis of PPPs and privatization more broadly has drawn upon multiple schools of thought including public choice, industrial organization, transaction cost, and property rights approaches (Bel, Fageda, & Warner, 2010, pp. 555-556; Petersen, Hjelmars & Vrangbæk, 2017, pp. 3-5). More recent models of PPPs such as Iossa & Martimort (2015) and Martimort & Pouyet (2008), focus primarily on the agency issues related to asymmetric information and the arising moral hazard problem to highlight the benefits arising from bundling project components in PPPs and the life-cycle cost perspective it imposes. These economic analyses of PPPs have relied on incentive theory in the presence of agency problems to evaluate the efficiency enhancing potential of PPPs, drawing on

previous work based on the theory of contracts and mechanism design with strategic interaction.<sup>12</sup> The benefits of bundling in a PPP, relative to conventional procurement, are reductions in moral hazard and agency costs associated with asset quality observance.

In this framework, the procuring government entity faces challenges observing the quality of the infrastructure asset being constructed in the design phase, with only the contractor having a full and costless understanding of the quality embedded in the asset they design and construct. Since under conventional procurement the builder gets paid based on delivery of the asset and have no stake in maintaining the asset or delivering services using the asset, they do not invest the resources or effort in making a higher quality asset that may more efficiently provide service over the lifetime of the asset. In these models PPPs can help solve this problem by contracting design, construction, maintenance, and service operations to a consortium of companies who are assumed to operate as a unified firm in relation to government. In these models, both the builder and the operator exert effort that directly increases the benefits of the project as a whole and may either increase or decrease operating costs depending on the nature of the technology employed. In the case where the builder's effort reduces operating costs, bundling provisions into a single contract generally results in superior social welfare outcomes. The effort gap between unbundled and bundled delivery can be bridged by contracting with the builder based on a quality index, but bundling remains superior as long as the index is imperfect (Iossa & Martimort, 2015, p. 19).

The problems arising in this situation from asymmetric information are distinct from those that arise due to incomplete contracts, where some relevant future scenario that may arise falls outside of the scope of the considerations detailed in the contract and/or is unenforceable at a low cost. The principal facing asymmetric information may still conceptually have access to a complete and costlessly enforceable contract such that the compensation of the agent can be set for all possible

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<sup>12</sup> This approach is referred to as the contract theory or incentive theory approach. For introductory volumes see Bolton and Dewatripoint (2005) and Laffont & Martimort (2002) and for a review.

outcomes that may be realized, but just cannot directly observe or contract effort levels. This point is emphasized by Hart (2003), who distinguishes between the theory of the firm as originally framed by Ronald Coase, looking at why and when firms contract out or vertically integrate (where the future is uncertain and complete contracts are not possible), compared to theories of privatization (where complete contracts are generally assumed such that all future relevant contingencies can be specified, but the contracting relationship suffers from agency problems based on asymmetric information). If contracts are complete ownership is irrelevant with the exception of who has rights to the residual asset value at the end of the contract.<sup>13</sup> These asymmetric information models then provide little rationale for the temporary transfer of asset ownership that is often part of PPP arrangements.

There is however a case to be made that, in general, government service procurement is prone to incomplete contracts given the challenges in most service delivery contexts with full specification of quality considerations (Hart, Shleifer & Vishny; 1997). If contracts are incomplete, ownership, and the discretion it provides, matter. With incomplete contracts, the owner of the asset has the discretion of what to do with the asset in contingencies arising outside of those specified in the contract. For longer term contracts such as SIBs and PPPs, with limited scope for renegotiation, this issue may become more acute. Hart's (1995) examination of the firm in the presence of incomplete contracts frames this general problem as viewing "power is a scarce resource" (p. 7) where the goal should be to allocate it optimally given the positive incentive effect of delegation, which trades with the decision-making power arising from ownership.

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<sup>13</sup> Residual asset value may affect investments in quality. See Grossman and Hart (1986) and Hart (2003). The conclusion regarding residual asset is echoed in more recent analysis of PPPs such as Iossa and Martimort (2015, p. 20), however, if there are additional informational asymmetries regarding and benefit levels cannot be observed, or a quality index cannot be contracted upon, transfer of ownership of the assets may be the only mechanism for internalizing externalities associated with unobservable effort levels. See also Martimort and Pouyet (2008, p. 401-403) for example. In the case of SIBs, social benefit is fundamental to the contract structure, and the assets, which are primarily composed of the designed social program and delivery structure, will likely be highly specific and non-transferable. This, paired with the highly labor-intensive nature of social service delivery and limited opportunity to patent any innovations will likely lead to a proportionally small residual value. This makes residual asset value and concerns over ownership of low significance in the case of SIBs under complete contracts, unless the patenting of the programs developed emerges as a key benefit of participation.

In the context of contracting out or privatization, this tradeoff is similar, but it has been argued the specificities of public delivery require some adaptation, or as Hart (2003) notes: it is inappropriate to “take an ‘off the shelf’ model from the theory of the firm literature and apply it to privatization” (p. C70). Under public delivery, the government faces a public-sector manager who can invest a non-verifiable effort in delivering a public service, or can contract out the service to a private firm. The entity with ownership rights has a greater incentive to invest, as they are the beneficiary in scenarios not specified in the contract, with the discretion or residual rights in these cases. The government faces similar agency problems: motivating the public or private manager to invest in quality enhancements through unverifiable effort levels. The tools available to incentivize that effort are also similar, with the opportunity to offer a spectrum of low to high powered compensation contracts.

It has been argued, however, that the public manager scenario creates additional challenges and the idea that public ownership leads to innovation by civil servants is unconvincing (Hart, 2003, p. C71). One reason that has been put forward is that the investment of the public manager may be appropriated by government and reallocated to other purposes without compensation. This leads to no effort being invested by civil servants. Instead others such as Hart (2003) and Bennett and Iossa (2006) model only contractors with the ability to exert the type of quality enhancing effort  $i$ , but also a second type of effort  $e$  focused on *quality shading*, such that both social benefit and costs are reduced. This quality shading is permitted to occur since contracts are incomplete and it is assumed that the verifiable and enforceable terms of the contract are still met. The research relying just on  $i$  and its associated set of assumptions leads to a promising case for the superiority of the PPP models over conventional procurement, while the incorporation of quality shading leads to less suggestive implications. The issue of quality shading is of particular significance in the SIB case, as a key issue central to the SIB design has been regarding the potential to misrepresent the quality or value-added of the service provided by selecting clients from the population that are easiest to serve or would be



the most likely to succeed without the intervention (Butler, Bloom, & Rudd, 2013; Callanan & Law, 2013; Warner, 2013). We therefore integrate both quality enhancing and quality shading efforts into the model below.

## b) Transaction Costs

While Hart's (2003) property rights approach draws upon asset specificity in his discussion as to what types of services are more or less likely to be more efficiently delivered under the PPP model, to keep his model parsimonious he puts aside the issue of public versus private ownership and delivery, a topic area whose analysis by economists has also centered on asset specificity. The trade-off in this transaction costs approach centered on asset specificity also relies on an incomplete contracting foundation. Here, contracting out draws upon the economies of scale and the associated incentive to invest in efficiency enhancements, in exchange for the discretion and flexibility to control production when done in-house. Sappington and Stiglitz (1987) argue that it is primarily within that transaction cost framework within a context of incomplete information that privatization decisions should be analyzed. With increasing specialization of the service, i.e. increased asset specificity, public ownership and delivery becomes more favorable, while the existence of transparent indicators and a high risk of cost overruns supports private delivery (Williamson, 1999, pp. 319-323; Williamson, 2002, p. 181). This is because as asset specificity increases, it becomes increasingly important to the principal to explicitly contract for contingent scenarios as the consequences of being 'held-up' by the agent are increasingly costly. This increases negotiation, administration and contracting costs, and the benefits of market delivery dissipate (Williamson 1981a, pp. 558-559; Williamson, 1981b, pp. 1548-1549). These two effects are neatly summarized by Williamson (1981) as "production cost" and "governance cost" effects (p. 559).

While the quality shading approach of Hart (2003) partially accommodates for Williamson's (1981) "production cost difference", it does not completely do so, and omits direct variation in "governance cost" between the in-house production and market procurement (p. 559). Public

production may be more costly, due for example to higher public-sector wages and benefits, but this may be more than offset by the higher governance costs. For a great proportion of public services, the assets developed are generally specific to the tasks at hand, which is plausible explanation for the high administration and transaction costs observed in PPPs.<sup>14</sup> Given the high degree of asset specificity in the SIBs, and given the small market and locally defined objective and population characteristics, SIBs would be predicted to have higher contracting costs, and this has also been documented in practice (KPMG, 2014; Loxley, 2017; Maier & Meyer, 2017; Morse, 2015; Tan et al., 2015).<sup>15</sup> Finally, another potential cost that is associated by private delivery is the threat of default and limited liability, and the associated transaction costs of holding firms accountable in these scenarios (Sappington & Stiglitz, 1987). In our model below, we incorporate exogenously determined differences in transaction costs as administrative costs, and differences in governance costs as part of varying baseline operations costs.

The focus on differences in production (or base costs) and governance (or administrative costs) have been central to an applied cost-effectiveness framework used to evaluate PPPs called Value for Money (VfM) Analysis.<sup>16</sup> VfM analysis does not have explicit theoretical micro foundations; it is simply an accounting method to compare variations in cost structure under competing delivery models. VfM analysis provides a clear process for breaking down costs by component, and could serve as an applied approach for evaluation for SIBs versus alternative delivery models should a formal analytical selection process be instituted by governments prior to procurement model selection. The UK Cabinet Office and Department for Digital, Culture, Media & Sport, for example, refer proponents to cost-benefit analysis tools to assist with the development of SIB proposals to help determine value-for-money. It should be noted however that VfM analyses of PPPs have not been

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<sup>14</sup> See Chong, Huet, Saussier & Steiner (2006), Loxley (2010), and Shaoul (2005).

<sup>15</sup> See also Chapter 3 in this volume. In general, PbR- based contracting will impose greater administration costs as additional as systems and processes need to be developed to track and quality assure data (Damberg, 2009).

<sup>16</sup> Cost effectiveness analysis refers to comparing the cost of competing delivery methods for where the project characteristics are predetermined or fixed. A full cost-benefit analysis may permit the production/delivery model to vary (Weinrott, Jones, & Howard, 1982, p. 179; Welsh, Farrington & Gowar, 2015, p. 457).

without controversy, and have been criticized for their high sensitivity to the choice of discount rate and tenuous cost estimates of risk transferred to private sector partners (Loxley, 2010, p. 173). VfM analysis is discussed more fully and compared to the principal-agent framework in Appendix D.

### c) The Significance of Competition

The role of competition has also been of central importance in the economic analysis of privatization (Sappington & Stiglitz, 1987). Public Choice theory makes the case against the public provision of goods and services given the position of the state as a monopoly service provider undisciplined by competitive markets, leading to inefficiencies and over-production (Bel, Fageda, & Warner, 2010, p. 555; Niskanen, 1971). The industrial organization literature however highlights that private markets may also have monopolistic tendencies, and public providers may face competition from other public providers and/or make be kept in check by the threat of privatization. This literature emphasizes that an analysis of privatization and its benefits requires simultaneously analyzing its impact on the degree of competition, and the results on such analysis will depend heavily on assumptions regarding the regulatory environment post-privatization (Vickers & Yarrow, 1988).

In 2014, the OECD convened experts and analysts to examine issues with respect to competition and PPPs, and concluded that: “The complexity of PPP contracts, caused by the bundling of various project phases, may lead to limited participation in the tender, especially by SMEs, and thus favor anticompetitive agreements among the few potential players. Also, bundling and long term contracting, typical for PPPs, could cause market foreclosure” (OECD, 2017). It is plausible that similar conditions have arisen in the case of SIBs, and we incorporate the ability for monopoly rents to be present in the case of bundled delivery in our model below.

### d) Corporate Social Responsibility

The concept of *Corporate Social Responsibility* (CSR) centres around the notion that not just non-profits, but also for-profit corporations and other businesses should be concerned with factors

beyond maximizing returns for owners and shareholders, such as social and environmental concerns, above and beyond what is legally required. McWilliams & Siegel (2001), for example define corporate social responsibility as “actions that appear to further some social good, beyond the interests of the firm and that which is required by law” (p. 117) and can be seen an in-kind dividend to firm owners who value the sought after social outcomes or as a reputational input into the firm itself. Such behaviour by large corporations is prevalent across sectors of the economy and has attracted significant resources (Baron, 2008), to the point where a specialized industry of CSR advisory services has developed in response (Graff, Zivin & Small, 2005, p. 1).

Economists’ skepticism of corporate actions in the public interest goes back at least to Adam Smith, with Milton Friedman a well-known objector to this view arguing back in 1970 that corporate executives have no special ability or insight leading to them to better allocate the entitlements of shareholders to charitable causes. Shareholders, not management, if they see fit, should allocate any surplus generated from firm operations to charity directly (Freidman, 2007; Freidman, 2009, pp. 133-136). Freidman argues that firms should focus on maximizing profits within the constraints “embodied in law and those embodied in ethical custom” (2007, pp. 173-174), a perspective that in the US has been reinforced by court rulings (Hiller, 2013, pp. 288-289). Friedman does however distinguish between acts of social responsibility based on the charitable preferences of executives, and actions taken that are construed as charitable, but are in fact taken to increase the profitability of the firm. He notes for example, a large employer in a small town may invest in local amenities to help attract and retain employees, or they may donate in response to tax incentives and the reputational effect that such donations may generate.<sup>17</sup> Other examples of CSR as a profit maximizing

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<sup>17</sup> While Friedman (2007) notes that he “cannot summon much indignation to denounce” these actions, he also notes his “admiration for those individual proprietors or owners of closely held corporations or stockholders of more broadly held corporations who disdain such tactics as approaching fraud” (p. 177).

strategy include the ability of producers to differentiate their product and charge higher prices, and the ability to divert social pressure and negative publicity (Baron, 2009, p. 8).

We incorporate a CSR effect into our model such that agents are willing to accept lower compensation given the socially beneficial nature of the project. This is similar to Pauly and Swanson (2017) who model investors as willing to take a reduced rate of return given their valuing the social benefit of the project. They also assume that all service providers are non-profit and altruistic, which results in them seeking only compensation sufficient to cover their costs. We suggest the altruism of NPOs would not limit them from seeking revenues greater than costs on a particular contract, as this would allow them to fund incremental activity they intrinsically value outside of the contract. In our model then, we explicitly model service providers as motivated by incremental revenues and can generalize service providers as being for-profit or non-profit.

#### IV. The Linear Contract Model

This section outlines a model of SIBs in relation to other publicly funded social service provision that combine and build on the insights of existing economic models of SIBs and PPPs. We incorporate two central ideas from previous studies of PPPs based on the incentive/contract theory framework: In the presence of asymmetric information with respect to agents' effort levels, bundling project components allows a greater unobservable effort to be extracted (Martimort & Pouyet, 2008; Iossa & Martimort, 2015), but in the presence of incomplete contracts this delegated contracting structure increases the potential for quality shading (Bennett & Iossa, 2006; Hart, 2003). We modify this framework by having all agents being able to contribute effort in improving program quality as well as quality shading. We also explicitly include fixed cost differentials specific to public versus private delivery, including administrative costs, which are emphasized in transaction cost approaches, and rents associated with the reduced competition in bundled contracts. Finally, we include a

reputational CSR effect that acts as alternative compensation to contractors who participate in the SIB.

Unlike previous SIB economic models, we explicitly model both direct public delivery and conventional procurement in addition to PbR and SIB contracts.<sup>18</sup> Under public delivery all project components are undertaken by government. In the stylized conventional publicly funded social service procurement, the government contracts a program designer to research and set up the program through one contract, then contracts separately for service delivery of the new program, with both contracts financed publicly. In the SIB case all components are contracted to a single firm, along with private financing.<sup>19</sup> For ease of exposition, a linear incentive contract is used to model the compensation structure of the agents under the contract models, where payments are made based on the benefits realized.

Throughout the exposition we will utilize SIBs in child welfare to illustrate our model. These programs seek to reduce foster care placement and support children staying safely with their families by providing service interventions to support positive parenting and stable home environments more generally. Our primary example will be the Cuyahoga County Partnering for Family Success program, a five-year \$4.0 Million SIB that combines 12 to 15 months of housing, counselling services and a number of other supports to 135 parents/guardians and their families (Social Finance, 2018). The program focuses on helping homeless mothers, who without housing are deemed unable to accept care of their children that have been apprehended by child welfare authorities (Lester, 2015). FrontLine is the lead service provider, linking clients to housing options and delivering “an evidence-based homelessness transition therapy known as “Critical Time Intervention”” (Pennell, 2014, p.1). Once housed, FrontLine also provides an array of ongoing supports through a caseworker

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<sup>18</sup> We find the assumption that SIBs can proceed while conventional funding is assumed unavailable arbitrary given that SIBs require approvals and decision at senior levels of government where such funding could also be prioritized.

<sup>19</sup> In Martimort and Pouyet (2008) and Iossa and Martimort (2015), government is contracting for an infrastructure project to be delivered either through joint contract design-build-operate PPP contract or conventionally through two separate contracts, one for design and construction, and another for operations.

with small caseloads, who makes regular visits and assists the parent with accessing education and training, healthcare, and addictions management services (Lester, 2015).

The principal-agent model is based on an exchange relationship between a principal who is the residual claimant on the outcome of a process, and an agent who is contracted and compensated to participate in that process. A specific type of agency problem, a *moral hazard* problem, arises when there are competing objectives or a conflict between the principal and the agent over hidden actions or efforts ( $i$ ) of the agent that impact the verifiable outcome or benefit ( $B$ ) of the process. Principal-agent models deviate from standard assumptions regarding contractual relations by recognizing that the actions of the agent are not possible or prohibitively costly to observe and verify directly, and that contracts cannot be written or enforced based on this information.<sup>20</sup> Instead, the principal can only contract based on the outcome  $B$  itself.

In the social service delivery case, the government is the principal hiring a service delivery agent to deliver a service outcome, but the government can't enforce a particular effort or quality of service by the service delivery agent; government can only observe the outcome of service intervention. For example, in the Cuyahoga County PfS program,  $B$  represents the reduction in days spent in foster care; the government is assumed to be capable of verifying the reduction in days in foster care for the children, but not the quality or treatment integrity of the Critical Time Intervention and other supports.

Take for example the following general specification of  $B$  with  $\eta$  being a normal random variable with mean of zero and variance of  $\sigma_\eta^2$ :

$$B = B(i, \eta)$$

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<sup>20</sup> An alternative version of the principal-agent problem is the *adverse selection* case which arises when the characteristics of the agent are unobservable, as opposed to the agent's actions, such that the agency issues is exogenous to the decision-making problem. While

$B$  is the valued observable outcome to the principal and is increasing in  $i$  and  $\eta$ , but action  $i$  is costly to the agent. Facing an asymmetric information problem with  $i$  and  $\eta$  being too costly or otherwise not feasible to observe and verify, the principal is restricted to paying the agent a transfer  $T$  based on  $B$  such that  $T = T(B)$ . If the agent is risk neutral and cannot observe  $\eta$  at the time that the agent chooses  $i$ , the optimum contract for the principal is a flat rate contract; if the agent is risk averse, the optimum contract will partially insure the agent against risk, which leads to only partial compensation to the agent for increases in  $i$  and creates an incentive for the agent to reduce effort short of the socially optimum level. In the Cuyahoga PfS program, county pays based on the number of foster days care reduced relative to a control group, specifically \$75 per day up to \$5Million total, but the program also covered project start-up costs and trials with charitable grants from a number of charities, including the George Gund Foundation, Cleveland Foundation, the Sisters of Charity Foundation of Cleveland and the Laura and John Arnold Foundation (Lester, 2015).

In our model, the agents are private firms, for-profit or non-profit, that may contract with the government, including a program design-builders ( $\mathcal{D}$ ) who set up the project, financiers ( $\mathcal{F}$ ) who invest capital in the project, and operators ( $\mathcal{O}$ ) who deliver the service. In the Cuyahoga PfS program, FrontLine is the operator of the program, along with housing providers including the Cuyahoga Metropolitan Housing Authority, Emerald Development and Economic Network, Inc. and the Famicos Foundation. The project designers include Enterprise Community Partners, Inc., who is the “Project Manager & Fiscal Agent” and Third Sector Capital Partners, the “Government Advisor & Transaction Coordinator” (Pennell, 2014). The financiers providing repayable investment in the project are listed in Table 4.1, and include a for-profit investor and several subordinate charitable investors.

Table 9			
<i>Cuyahoga County Partnering for Family Success Pay for Success Program Investors</i>			
<u>Investor</u>	<u>Amount</u>	<u>Lender Status and Financing</u>	<u>Interest</u>
		<u>Type</u>	<u>rate</u>
Reinvestment Fund	\$1,575,000	Senior, loan	5%



George Gund Foundation	\$725,000	Subordinate, loan	2%
George Gund Foundation	\$275,000	Subordinate, loan	0%
Nonprofit Finance Fund	\$325,000	Subordinate, loan	2%
Cleveland Foundation	n.a.	Subordinate,	2%
Sisters of Charity Foundation of Cleveland	\$150,000	recoverable grants	
Sisters of Charity Foundation of Cleveland	n.a.	Subordinate,	2%
Note: Data from Pennell (2014)			

Firms can form a consortium and deliver multiple services under a single contract with government, for example, as a joint designer-operator (*DO*), or a consortium of all providers (*DFO*) in a SIB. Below we assume for clarity of depiction that there is only one provider in each role; the model can easily be generalized to multiple agents of each type. The social program intervention yields a verifiable present value monetized social benefit savings of:

$$B = b_0 + \mathbf{b}\mathbf{i} - \mathbf{d}\mathbf{e} + \eta$$

with:

$$\mathbf{b} = [b_1 \quad b_2 \quad b_3], \mathbf{i} = \begin{bmatrix} i_1 \\ i_2 \\ i_3 \end{bmatrix}, \mathbf{e} = \begin{bmatrix} e_1 \\ e_2 \\ e_3 \end{bmatrix}, \mathbf{d} = [d_1 \quad d_2 \quad d_3],$$

where  $i_1$  is the productive investment effort by the designer to improve project design quality through research and development of the social service,  $i_2$  is productive effort invested by the financier in improving operations quality, and  $i_3$  is the investment exerted by the operator in improving operations quality.<sup>21</sup>

<sup>21</sup> Some authors such as Iossa and Martimort (2015, pp. 25-30) model the welfare enhancing potential of private finance arising from the financiers' access to a signal on the effort level of the operator. While this expertise may exist with respect to infrastructure assets, it is unlikely that financial firms would have any particular strength in the evaluation of social programs. To simplify the exposition, we treat private financiers as another member of the consortium, like the designer, whose productive efforts can be tapped to reduce operating costs and increase social benefit, but may also partake in quality shading as well.

In our model, agents may also exert quality shading effort  $e$  that reduces costs and reduces performance on the verifiable benefit  $B$  on which performance payments are based, with  $e_1, e_2, e_3$  representing the levels of this quality shading effort exerted by the designer, financier and operator respectively.<sup>22</sup> This could include for example operators engaging a lower wage precarious workforce to deliver services, or designers setting up the services in a low cost but inconvenient location. Agents may also engage in a third type of effort ( $f$ ) which is also quality shading in that it reduces the overall social welfare  $W$  generated by the program, but it is non-verifiable and does not impact  $B$ . For example, private agents may select easy-to-serve or less needy clients who may easily meet target thresholds for  $B$  but benefit relatively less from the intervention.<sup>23</sup> Another example would be underserving clients assigned to the program who are harder to serve and less likely to meet thresholds for  $B$ . As discussed in chapter 3, several child welfare and early childhood development SIBs have been accused of these creaming and parking activities.

In our model all types of effort are constrained to be non-negative. In scenarios where either design, finance or operations are undertaken publicly, it is assumed due to the hold-up problem that the public agent does not exert any effort such that  $i_j = 0$ , and that the information advantages and incentive structure of within-government delivery prevents quality shading such that  $e_j = f_j = 0$ .

$b_0$  is the baseline benefit of the project when no effort is exerted in quality enhancements or quality shading, subject to  $\eta$ , a random shock with a mean of zero and variance  $\sigma_\eta^2$ . Parameter vectors  $\mathbf{b}$ ,  $\mathbf{f}$  and  $\mathbf{d}$  capture the direct marginal impact of designer, financier and operator effort on overall social welfare  $W$ , and all are assumed greater than zero unless otherwise noted. It is also assumed that the government can directly observe the social benefit  $B$  but not effort levels.<sup>24</sup>

<sup>22</sup> See Heckman, Heinrich, & Smith (2011b, p. 48-49) for an application of in the social services context.

<sup>23</sup> In the case of a randomized control trial, this would require subverting the randomization process in some way. While the stylized SIB model uses randomized control trials, in practice many projects have used less rigorous evaluation frameworks. See Carter et al. (2018) and Fraser, Tan, Lagarde and Mays (2018).

<sup>24</sup> The assumption that government can directly observe social benefit is a more appropriate assumption with SIBs projects that target indicators such as criminal recidivism rates, participation in welfare programs, school outcomes, and formal labor market attachment, where the government has administrative data that can be utilized that closely reflects the targeted outcomes with a clear measurement of associated cost reductions of a successful intervention. Alternatively, one could model benefit as an index subject to random error,

Project operating costs  $C_O$  are specified through a cost function that shows a present value of costs based on effort levels of the agents:

$$C_O = c_O - \delta i - \gamma e - \chi f + \varepsilon$$

where:

$$\delta = [\delta_1 \quad \delta_2 \quad \delta_3], \gamma = [\gamma_1 \quad \gamma_2 \quad \gamma_3], \chi = [\chi_1 \quad \chi_2 \quad \chi_3], f = \begin{bmatrix} f_1 \\ f_2 \\ f_3 \end{bmatrix},$$

$c_O$  are baseline operations costs which can vary by delivery model, with a superscript G denoting baseline costs under public delivery; vector  $\delta$  reflects the marginal impact of productive investment efforts spent on reducing cost; and vectors  $\gamma$  and  $\chi$  reflect the cost-reducing marginal impacts of verifiable and non-verifiable quality shading efforts, with all elements of  $\gamma$  being greater than zero. It is also assumed, following Hart (2003), that both types of quality shading activity are not socially beneficial, such that the reduction in costs is less than the reduction in social benefit. For example,  $d_j > \gamma_j$  for all  $j$ . Costs are stochastic and  $\varepsilon$  is a random shock with a mean of 0 and variance of  $\sigma_\varepsilon^2$ . Design-build costs  $C_D$  are equal to  $c_D$  when design is contracted out and  $c_D^G$  when design is in-house. As noted by Sappington and Stiglitz (1987), financing costs  $C_F$  can vary depending on the delivery model, with private sector facing higher borrowing costs, disadvantaging privatization. Let total financing costs equal  $(1 + v)\lambda(T + A)$ , where  $v$  is the interest rate on borrowing to finance the project,  $\lambda$  is the cost of public funds due to funds being raised through distortionary taxation,  $T$  is the total value of the transfer to the agents, and  $A$  is the auxiliary or administrative costs, which itself is a function of asset specificity. For simplicity of exposition below, let  $\theta = (1 + v)\lambda$ , and in the case of public financing normalize  $\theta_G = 1$ ; also let  $\theta_p > 1$  in the case of private finance so that  $\theta_p$  is the ratio of cost private to public finance.  $c_O, c_D, C_F$  and  $b_0$  are assumed observable such that there is no issue with adverse selection.

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such that the government has access only to an estimate of the benefit, which introduces additional risk and compensation costs for the risk-averse agents.

Following Iossa and Martimort (2015), effort spent on increasing design-build quality can either increase or decrease operating costs and this is reflected by the sign of  $\delta_j$ , which can be positive or negative depending on the project type. If  $\delta > 0$ , quality investments in design lead to reduced operations cost, for example where a better designed social program requires fewer program staffing hours. A  $\delta < 0$  reflects where more advanced technological investments result in more complicated operational requirements, but requires more specialized staff with higher training and compensation expenses. For example, in the Cuyahoga PFS project, the increased number of interventions and direct supports built into the project will require the hiring of additional qualified staff, increasing costs.

Effort levels are unverifiable by government and are assumed to have quadratic monetary costs equal to:

$$\psi_{i_j}(i) = \frac{i_j^2}{2}, \psi_{e_j}(e) = \frac{e_j^2}{2}, \psi_{f_j}(f) = \frac{f_j^2}{2}$$

such that the marginal monetary cost of effort is equal to the effort level itself. Total disutility of effort for all agents is then equal to:

$$\Psi = \frac{\mathbf{e}'\mathbf{e} + \mathbf{i}'\mathbf{i} + \mathbf{f}'\mathbf{f}}{2}$$

Where prime represents the transpose function, such that  $\mathbf{e}'$  is the transpose of vector  $\mathbf{e}$ , etc. A risk averse agent  $j$ 's payoff from participating in the contract  $U_j$  is a function of the transfer  $T$  it receives from government, costs  $C_j$  incurred, the monetized disutility of effort  $\psi$ , the risk premium  $R_j$  based on a constant absolute degree of risk aversion  $r$ , the corporate social responsibility effect  $\varphi_j$  it benefits from participating in the project, similar to that proposed by Costa & Shah (2013), Liebman and Feller (2014, p. 16), etc.:

$$U_j = T_j - C_j - \psi_{i_j}(i_j) - \psi_{e_j}(e_j) - \psi_{f_j}(f_j) - R_j + \varphi_j$$

The general form of  $T_j$  is a linear incentive contract, in our examples based on the benefit level  $B$ :

$$T(B) = \alpha + \beta B$$

where  $\beta$  is a parameter, set by the government, that can take values from 0 to 1, such that if  $\beta = 0$  is a pure fixed price contract where the contractor receives  $\alpha$ . If  $\beta = 1$  the operator is fully rewarded for any increase in social benefit generated from the project. In the case of the Cuyahoga county project, the county government is paying \$75 per day of foster care avoided, up to a maximum of \$5 Million, and the project was also as noted supported by a number of grants for an unspecified total, but more than \$780,000.

As is standard in models of this type, it is assumed that in unbundled cases that government bargaining power and market competition is sufficient to fully extract any economic profits through a competitive auction mechanism such that the payoff is reduced to zero, which is assumed the agent's next best alternative:<sup>25</sup>

$$T_j = C_j + \psi_{i_j}(i_j) + \psi_{e_j}(e_j) + \psi_{f_j}(f_j) + R_j - \varphi_j$$

This is the participation constraint of the agent in the unbundled case. In the bundled case, due to rents arising from restrained competition,  $U$  is non-zero and added to  $T$ . Also assume arbitrarily that consumption of the corporate social responsibility benefits  $\varphi$  are a non-rival externality of participating in the contract, such that consumption by one agent does not impinge on other agents receiving this benefit, nor does it reduce the benefit  $B$  society receives from the program. Also assume that  $\varphi$  is only accessible to private partners, for reasons similar to the standard hold up problem claimed to exist in the public sector.<sup>26</sup> The government representative is assumed risk neutral and to maximize the following payoff function:<sup>27</sup>

$$P = B - \theta T - \theta_G A$$

<sup>25</sup> See also Engel et al. (2013), Hart (2003), and Martimort and Pouyet (2008). One suggested mechanism through which this could be achieved would be through a Demsetz auction mechanism. See Demsetz (1968), Harstad and Crew (1999), Laffont & Tirole (1993, ch. 7-8), and Spulber (1989, Ch.9) for further discussion. The competitive assumption puts forward the best-case scenario for the PPP delivery method, if one assumes that movement away from competition results in higher prices and that competition for larger bundled projects will be lesser than for unbundled projects. Alternatively, one could model a surplus being divided according to a Nash bargaining or some other process: see Bennett and Iossa (2006) for example.

<sup>26</sup> Hart (2003).

<sup>27</sup> We then adopt more conventional public finance assumptions regarding risk aversion, with the government being risk neutral and the private sector agents as risk averse, as opposed to Pauly and Swanson (2017) and Wong et al. (2016) who assume the reverse: a risk averse government and a risk neutral private sector agents.

where  $T = \sum_j T_j$ , and  $0 < A_{Min} \leq A$  is administration or transaction costs borne by the government. Based on Williamson's governance cost concept discussed above, administrative costs for public delivery ( $A^G$ ) are less than administrative costs for conventional procurement ( $A^C$ ), which are less than for the administrative costs found in the SIB case ( $A^{SIB}$ ). The net social welfare generated by the project is:

$$W = P - \mathbf{x}\mathbf{f}$$

where  $\mathbf{x} = [x_1 \ x_2 \ x_3]$

A number of scenarios can be generated based on the above general framework with the differing assumptions regarding private versus public delivery, the type of incentive contract offered, and the bundling or unbundling of contracts. The exposition below is restricted to three cases of publicly funded social service provision: Publicly designed, financed and delivered social service provision; conventional publicly financed service purchase model where both the design-builder and the service delivery agent receives a fixed price contract; and a fully bundled and contracted out model, which represents the SIB model. Two publicly financed Pay-by-Results (PbR) type contracts, which can be viewed as intermediate steps between conventional procurement and an SIB, are outlined in Appendix E.

#### a) First Best Comparator

Similar to Hart (2003), Martimort and Pouyet (2008), and Iossa and Martimort (2015), we start with a first-best (FB) scenario where effort levels are observable, verifiable, and specified in a costlessly enforceable contract, with the government fully insuring the risk averse contractor such that  $R_j = R = 0$ . In this case, the principal-agent problem is assumed away and the principal can contract directly for effort levels. This leads to effort levels that maximize expected social welfare in

the first-best case ( $W^{FB}$ ). Here the marginal costs of efforts are equal to the marginal social benefits, both directly on the quality of service delivered and indirectly through the cost function:<sup>28</sup>

$$\begin{aligned}
 (\mathbf{i}^{FB}, \mathbf{e}^{FB}, \mathbf{f}^{FB}) &= \arg \max_{\mathbf{i}, \mathbf{e}, \mathbf{f}} E \left[ W^{FB} \right. \\
 &= b_0 - c_D - c_O + (\mathbf{b} + \boldsymbol{\delta})\mathbf{i} - (\mathbf{d} - \boldsymbol{\gamma})\mathbf{e} - \mathbf{x}\mathbf{f} - \frac{\mathbf{e}'\mathbf{e} + \mathbf{i}'\mathbf{i} + \mathbf{f}'\mathbf{f}}{2} + \sum_j \varphi_j - A_{Min} \left. \right] \\
 i_j^{FB} &= \begin{cases} b_j + \delta_j & \text{if } b_j + \delta_j \geq 0 \\ 0 & \text{if } b_j + \delta_j < 0 \end{cases} \\
 \mathbf{e}^{FB} &= \mathbf{0} \\
 \mathbf{f}^{FB} &= \mathbf{0}
 \end{aligned}$$

Where  $\Sigma\varphi = \varphi_1 + \varphi_2 + \varphi_3$

This is the first-best baseline, assuming perfect information and contracting on effort levels, which in turn makes the contracting form irrelevant; either bundled or unbundled provision will achieve the optimum result. Private delivery results in a higher level of welfare but solely based on the assumptions regarding corporate social responsibility benefit  $\varphi$  being a non-rival and only available to private contractors – if public sector managers also received this benefit private and public delivery would be equivalent. Since  $\mathbf{e}$  and  $\mathbf{f}$  are assumed to be socially detrimental and are restricted to be non-negative, the optimum levels of quality shading effort in the first best scenario is  $\mathbf{0}$  for each agent. The optimal investment in quality-enhancing effort is equal to the direct marginal benefit  $b_j$  plus the marginal impact on costs  $\delta_j$ , except when the technology is such that this effort leads to higher costs (i.e.  $\delta_j < 0$ ), and these higher costs outweigh the direct marginal benefits  $b_j$ . In this latter case the optimum is a corner solution of zero due to the non-negativity constraint on  $i_j$ . The expected level of social welfare generated in the first-best scenario is:

<sup>28</sup> The marginal cost of efforts expended on increasing operations quality ( $i$ ) are equal to the direct marginal benefit produced ( $b$ ) plus the impact on costs ( $\delta$ ).

$$E[W^{FB}] = b_0 - c_D - c_O + \left\{ \sum_j \frac{(b_j + \delta_j)^2}{2} \mid b_j + \delta_j \geq 0 \right\} + \sum_j \varphi_j - A_{Min}$$

## b) Public Design, Finance and Delivery

Publicly designed, financed and delivered social service provision provides the simplest result given the assumptions of the model. Government is the residual claimant on any surplus and given the assumptions of the model, the public-sector workers' status as an employee leaves them with no incentive to improve quality or reduce costs. Due to the hold-up problem arising, public sector workers do not exert any effort in either productive investment or quality shading, leading to:

$$\mathbf{e}^G = \mathbf{i}^G = \mathbf{f}^G = \mathbf{0},$$

with the following associated level of welfare:

$$E[W^G] = b_0 - c_D^G - c_O^G - A^G$$

The difference in welfare compared to the first best scenario is:

$$E[W^G] - E[W^{FB}] = -(c_D^G - c_D) - (c_O^G - c_O) - \left\{ \sum_j (b_j + \delta_j)^2 \mid b_j + \delta_j \geq 0 \right\} - \sum_j \varphi_j - (A^G - A_{Min})$$

## c) Conventional Procurement

Under a publicly financed conventional social service procurement framework, both the designer and service operator are paid separate fixed price contracts  $T_O^C = \alpha_O^C$  and  $T_D^C = \alpha_D^C$  respectively.  $\alpha_O^C$  and  $\alpha_D^C$  are determined through the bidding process on the contract. It is assumed that competition will lead to an  $\alpha_O^C$  and  $\alpha_D^C$  such that the winning bidders are just willing to take their respective contracts. Since the designer is paid a fixed price contract and is not responsible for or impacted by operating costs, the designer does not expend either quality enhancing or quality shading effort, such that  $i_1 = e_1 = f_1 = 0$ .<sup>29</sup> The public financier, again due to the hold-up problem, exerts no effort and

<sup>29</sup> Here we assume that in conventional procurement the government contracts for design. The project could equally be designed by the public sector at cost  $c_D^G$ .



$i_2 = e_2 = f_2 = 0$ . This is presumably the status quo case in the Cuyahoga county case, given FrontLine's status as a contract agency of the Alcohol, Drug Addiction & Mental Health Services Board of Cuyahoga County. Government specifies the overall service delivery structure, and contracts with an external entity who gets a fixed cost contract to deliver services to a certain number of clients per year. The cost function facing the operator then reduces to:

$$C_0 = c_0 - \delta_3 i_3 - \gamma_3 e_3 - \chi_3 f_3 + \varepsilon$$

The operator seeks to maximize its payoff:

$$(i_3^C, e_3^C, f_3^C) = \arg \max_{i, e \geq 0} \left[ E[U_0^C] = \alpha_0^C - c_0 + \delta_3 i_3 + \gamma_3 e_3 + \chi_3 f_3 - \frac{i_3^2}{2} - \frac{e_3^2}{2} - \frac{f_3^2}{2} - \frac{r\sigma_\varepsilon^2}{2} + \varphi_3 \right]$$

$$i_3^C = \begin{cases} \delta_3 & \text{if } \delta_3 \geq 0 \\ 0 & \text{if } \delta_3 < 0 \end{cases}$$

$$e_3^C = \gamma_3$$

$$f_3^C = \chi_3$$

Here we adopt the first order approach, with assumes that there is a unique solution to the optimization problem.<sup>30</sup> Since the operator is fully responsible for costs, she sets effort levels equal to the marginal cost-reducing benefit, subject to non-negativity constraint. A service provider such as FrontLine will set effort levels equal to their marginal benefit, which in this case refers to the reduction operation costs. Welfare in the conventional procurement case ( $W^C$ ) is equal to:

$$E[W^C] = b_0 - c_D - c_0 + \left\{ \frac{\delta_3^2}{2} + b_3 \delta_3 \mid \delta_3 \geq 0 \right\} - \left( d_3 \gamma_3 - \frac{\gamma_3^2}{2} \right) - \left( x_3 \chi_3 - \frac{\chi_3^2}{2} \right) - \frac{r\sigma_\varepsilon^2}{2} + \varphi_3 - A^C$$

Conventional procurement will be superior to public design and delivery if  $E[W^C] - E[W^G] \geq 0$ , or:

<sup>30</sup> Note this is a strong assumption and has been the subject of extensive discussion in the incentive theory literature. See Grossman & Hart (1983), Hölmstrom (1979), Hölmstrom and Milgrom (1987) and Mirrlees (1999).

$$\begin{aligned}
& (c_D^G - c_D) + (c_O^G - c_O) + \left\{ b_3 \delta_3 + \frac{\delta_3^2}{2} \mid \delta_3 \geq 0 \right\} + \varphi_3 \\
& \geq \left( d_3 \gamma_3 - \frac{\gamma_3^2}{2} \right) + \left( x_3 \chi_3 - \frac{\chi_3^2}{2} \right) + \frac{r \sigma_\varepsilon^2}{2} + (A^C - A^G)
\end{aligned}$$

such that savings on baseline costs due to lower private sector costs  $[(c_D^G - c_D) + (c_O^G - c_O)]$ , the net benefit of investment in quality by the service provider  $(b_3 \delta_3 + \frac{\delta_3^2}{2})$ , and the generated corporate-social responsibility benefits  $(\varphi_3)$ , are sufficient to offset the net benefit reduction due to quality shading by the service provider  $(d_3 \gamma_3 - \frac{\gamma_3^2}{2}) + (x_3 \chi_3 - \frac{\chi_3^2}{2})$ , the operator's risk premium  $(\frac{r \sigma_\varepsilon^2}{2})$ , plus any increase in transaction costs  $(A^C - A^G)$ .

#### d) Social Impact Bond: Pay by Results - Fully Bundled Delivery

Social Impact Bonds fully bundle private design, finance and delivery under a single PbR contract. In this case in our current framework, utilizing a linear payment scheme, the designer-financier-operator consortium then receives a single contract based on a reimbursement rule with a fixed payment portion and a portion based on social benefit outcomes:<sup>31</sup>

$$T^{SIB}(B) = \alpha^{SIB} + \beta B$$

The consortium optimizes its effort levels to maximize expected payoff:<sup>32</sup>

$$\begin{aligned}
(\mathbf{i}^{SIB}, \mathbf{e}^{SIB}, \mathbf{f}^{SIB}) &= \arg \max_{\mathbf{i}, \mathbf{e}, \mathbf{f} \geq \mathbf{0}} \left[ E[U^{SIB}] \right. \\
&= \alpha^{SIB} + \beta b_0 - c_D - c_O + (\beta \mathbf{b} + \boldsymbol{\delta}) \mathbf{i} + (\boldsymbol{\gamma} - \beta \mathbf{d}) \mathbf{e} + \boldsymbol{\chi} \mathbf{f} - \frac{\mathbf{e}' \mathbf{e} + \mathbf{i}' \mathbf{i} + \mathbf{f}' \mathbf{f}}{2} \\
&\quad \left. - \frac{r(\sigma_\varepsilon^2 + \sigma_\eta^2 \beta^2)}{2} + \sum_j \varphi_j \right]
\end{aligned}$$

<sup>31</sup>Liebman (2011, p. 16) discusses briefly the implications of economic theory and the optimality of a mixed payment structure for SIBs.

<sup>32</sup>This assumes that under an SIB all agents are motivated by the payout. In a stylized SIB, it is only the investors that is paid by results, although at least 25 SIBs have organizations providing services through the SIB that have also been compensated based on results. See Chapter 1 footnote 23 for details. Even in the case of non-pecuniary motivation, there are arguments why service providers and intermediary would be motivated to deliver on results in an SIB, based on for example, reputational effects. See Chapter 5 for further discussion.

$$i_j^* = \begin{cases} \beta b_j + \delta_j & \text{if } \beta b_j + \delta_j \geq 0 \\ 0 & \text{if } \beta b_j + \delta_j < 0 \end{cases}$$

$$e_j^* = \begin{cases} \gamma_j - \beta d_j & \text{if } \gamma_j - \beta d_j \geq 0 \\ 0 & \text{if } \gamma_j - \beta d_j < 0 \end{cases}$$

$$f_j^* = \chi_j$$

Each agent is now assumed, as part of the consortium, to have a vested interest in the outcome and efficiencies of operations, and therefore may exert both quality enhancing and quality shading effort. This may be due the individual stakeholder being paid by results, the residual claimant status of the consortium collectively to any surplus generated, or reputational effects. Stakeholders set effort such that marginal benefits equal marginal costs, but marginal benefits now include the flow through of incentive payments, in addition to their cost reducing impact on operations.

In the case of the Cuyahoga county SIB, the service package to clients is claimed to be enhanced based on the SIB structure, and now includes housing supports, smaller caseloads, educational and training supports in addition to the therapy services of FrontLine, which is also enhanced based on research on best practice. These costly additions, under conventional procurement program, may not have been pursued since they increase rather than decrease operational costs. Now, since the consortia is being paid based on outcomes, and these investments have been shown to improve outcomes, they may be undertaken. The negative impact of the SIB model is that it also induces quality shading effort from financiers and designers that was not present in conventional procurement. Investors and designers now have an incentive to reallocate support for unobserved outcomes or compromise on these objectives to focus solely on the measure outcomes. In the Cuyahoga County PfS project, the consortium has an incentive to reallocate resources away from, for example, academic supports for the children towards services that directly reduce days in foster care.

The government sets  $\beta^{SIB}$  to maximize its payoff taking the optimum effort levels of the agents as given:

$$\begin{aligned}\beta^{SIB} &= \arg \max_{\beta} \left[ E[P^{SIB}] \right. \\ &= b_0 - \theta_P(c_D + c_O) + (\mathbf{b} + \theta_P \boldsymbol{\delta}) \mathbf{i}^* + (\theta_P \boldsymbol{\gamma} - \mathbf{d}) \mathbf{e}^* + \theta_P \boldsymbol{\chi} \mathbf{f}^* \\ &\quad \left. - \frac{\theta_P \mathbf{i}^{*'} \mathbf{i}^* + \theta_P \mathbf{e}^{*'} \mathbf{e}^* + \theta_P \mathbf{f}^{*'} \mathbf{f}^*}{2} - \frac{\theta_P r (\sigma_{\varepsilon}^2 + \sigma_{\eta}^2 \beta^2)}{2} + \theta_P \sum_j \varphi_j - A^{SIB} - U^{SIB} \right]\end{aligned}$$

Ruling out corner solutions such that some positive level is optimal for all agents for all effort types.<sup>33</sup>

$$\beta^{SIB} = \frac{\mathbf{b}\mathbf{b}' + \mathbf{d}\mathbf{d}'}{\theta_P(\mathbf{b}\mathbf{b}' + \mathbf{d}\mathbf{d}' + r\sigma_{\eta}^2)}$$

As the risk premium approaches zero and the cost of private finance approaches the cost of public finance, the optimal contract approaches a full flow-through of incentives. This provides a hypothesis, for the variation in practice with respect to degree to which guarantees are provided to private investors by government and foundations in SIBs. If set optimally, greater guarantees will reflect higher risk aversion and/or a higher cost of private finance. The expected payoff function for the government with an SIB contracting structure can be rearranged as follows:

$$\begin{aligned}E[W^{SIB}] &= b_0 + \beta^{SIB} \left( 1 - \frac{\theta_P \beta^{SIB}}{2} \right) (\mathbf{b}\mathbf{b}' + \mathbf{d}\mathbf{d}') + \left( \mathbf{b}\boldsymbol{\delta}' + \frac{\theta_P \boldsymbol{\delta}\boldsymbol{\delta}'}{2} \right) - \left( \mathbf{d}\boldsymbol{\gamma}' - \frac{\theta_P \boldsymbol{\gamma}\boldsymbol{\gamma}'}{2} \right) \\ &\quad - \left( \mathbf{x}\boldsymbol{\chi}' - \frac{\theta_P \boldsymbol{\chi}\boldsymbol{\chi}'}{2} \right) - \theta_P \left( c_D + c_O + \frac{r(\sigma_{\varepsilon}^2 + \sigma_{\eta}^2 (\beta^{SIB})^2)}{2} - \sum_j \varphi_j \right) - A^{SIB} - U^{SIB}\end{aligned}$$

where  $\beta^{SIB} \left( 1 - \frac{\theta_P \beta^{SIB}}{2} \right) (\mathbf{b}\mathbf{b}' + \mathbf{d}\mathbf{d}')$  is the incremental net benefit generated from the partial internalization of externalities by the agent due to partial flow through of benefits,  $\left( \mathbf{b}\boldsymbol{\delta}' + \frac{\theta_P \boldsymbol{\delta}\boldsymbol{\delta}'}{2} \right)$  is remaining net benefit of effort spent on quality enhancements due to the consortia taking into account the impact of upfront investment in quality on operations cost; and  $\left( \mathbf{d}\boldsymbol{\gamma}' - \frac{\theta_P \boldsymbol{\gamma}\boldsymbol{\gamma}'}{2} \right) + \left( \mathbf{x}\boldsymbol{\chi}' - \frac{\theta_P \boldsymbol{\chi}\boldsymbol{\chi}'}{2} \right)$  is the net benefit reduction due to quality shading motivated by cost reductions. This payoff will be greater than the conventional case if the benefit increase due to incentive payments,

<sup>33</sup> See Appendix E for more detailed exposition of the publicly financed PbR models and for discussion of corner solution scenarios.

the net increase in benefit due to increased quality investment, plus the increase in CSR, is greater than the increase in base costs due to higher cost of private finance, the net increase in quality shading, the increased risk premium due both to the increased variance due to benefit flow through and higher cost of private finance, plus any increased administration costs. I.e.  $E[W^{SIB}] - E[W^C] > 0$  if:

$$\begin{aligned} & \beta^{SIB} \left( 1 - \frac{\theta_P \beta^{SIB}}{2} \right) (\mathbf{b}\mathbf{b}' + \mathbf{d}\mathbf{d}') + \left( \mathbf{b}\boldsymbol{\delta} - b_3\delta_3 + \frac{\theta_P \boldsymbol{\delta}\boldsymbol{\delta}'}{2} - \frac{\delta_3^2}{2} \right) + \theta_P \sum_j \varphi_j - \varphi_1 - \varphi_2 \\ & > (\theta_P - 1)(c_D + c_O) + \left( \mathbf{d}\boldsymbol{\gamma} - d_3\gamma_3 - \frac{\theta_P \boldsymbol{\gamma}\boldsymbol{\gamma}'}{2} + \frac{\gamma_3^2}{2} \right) - \left( \mathbf{x}\boldsymbol{\chi} - x_3\chi_3 - \frac{\theta_P \boldsymbol{\chi}\boldsymbol{\chi}'}{2} + \frac{\chi_3^2}{2} \right) \\ & + \frac{(\theta_P - 1)r\sigma_\varepsilon^2}{2} + \frac{(\theta_P - 1)r\sigma_\varepsilon^2}{2} + \frac{\theta_P r\sigma_\eta^2 (\beta^{SIB})^2}{2} + (A^{SIB} - A^C + U^{SIB}) \end{aligned}$$

The results of the above modelling approach can be summarized as follows. Bundling and contracting out social service delivery under an SIB has benefits and costs relative to conventional procurement. The benefits include: a more optimal investment in design quality, a corporate social responsibility benefit for private contractors that reduces the cost of hiring them, and a partial internalization of externalities associated with efforts of the contractor to improve or shade the verifiable design quality of the social program. The incremental costs include: higher financing costs, greater quality shading, compensation of risk averse agents for taking on risk, greater administration costs, and newly generated monopoly rents. SIBs are likely to be superior when contractors are less risk averse relative to government and/or obtain a high CSR benefit, and the net marginal impact of quality enhancements are large relative to the impact of quality shading.

In the Cuyahoga County PFS project, the incremental benefits amount to the positive behavioral shifts induced by the incentive payments for keeping children out of foster care; the incidental benefit generated to government from designers and financiers now putting effort into quality improving cost reductions; and the greater CSR impact achieved by the Reinvestment Fund and various local foundations. The incremental costs of the SIB include: The financing differential between the county's

public borrowing rate and the return paid to the reinvestment fund and the foundations; cost cutting measures implemented that reduce both the program operating costs as well as the benefits of the program due to the Reinvestment Fund, the foundations, Enterprise Community Partners, and Third Sector Capital Partners, all having a residual claim on any cost reductions; new risk compensation for these new agents involved; the shifting of resources away from unmeasured outcomes such as child success in school and potential gaming activities such as parking the hardest to serve clients; greater administration costs; and the reduction in competition and subsequent rents to agents due to the negotiated nature of the SIB.

## V. Implications of non-linear incentive contracts

The model developed above is based on a linear incentive contract for compensation  $T(B) = \alpha + \beta B$ , where  $\beta$  is set to maximize the payoff of the contract-issuing government. Early theoretical results analyzing moral hazard found that within the incentive framework the optimum compensation structure would be non-linear and complex (Grossman & Hart, 1983; Hölmstrom, 1979; Mirrlees, 1999), however later results suggested that, due to the ability of agents to take advantage of non-linearities through strategic action, that linear contracts may be optimal (Hölmstrom & Milgrom, 1987). In practice however, many incentive contracts do take simple non-linear forms, such as a base compensation over a certain range plus a bonus after a certain level of benefit is reached, and a number of studies have sought out conditions under which such a contract may be optimal (see: Au & Kawai, 2014; Herweg, Müller, & Weinschenk, 2010; and Oyer, 2000). A similar approach has been applied in the case where compensation also may be constrained to fall within a certain range, for example with a guaranteed minimum payment and a cap on available compensation (see: Jewitt, Kadan & Swinkels, 2008).

In these cases, SIB contracts can be thought of as following a step function containing  $n + 1$  intervals, such that:

$$T_k^{SIB} = \begin{cases} \alpha_n^{SIB} & \text{if } \tilde{B}_n \leq B \\ \alpha_{n-1}^{SIB} & \text{if } \tilde{B}_{n-1} \leq B < \tilde{B}_n \\ \vdots & \vdots \\ \alpha_1^{SIB} & \text{if } \tilde{B}_1 \leq B < \tilde{B}_2 \\ \alpha_0^{SIB} & \text{if } B < \tilde{B}_1 \end{cases}$$

where  $\tilde{B}$  represents the boundaries of the intervals generating the targeted social benefit range. In a simple two-outcome model:

$$T = \begin{cases} \alpha_h^{SIB} & \text{if } \tilde{B} \leq B \\ \alpha_l^{SIB} & \text{if } B < \tilde{B} \end{cases}$$

Or:

$$T = \begin{cases} \alpha_h^{SIB} & \text{if } b_0 + \mathbf{b}\mathbf{i} - \mathbf{d}\mathbf{e} + \eta - \tilde{B} \geq 0 \\ \alpha_l^{SIB} & \text{if } b_0 + \mathbf{b}\mathbf{i} - \mathbf{d}\mathbf{e} + \eta - \tilde{B} < 0 \end{cases}$$

We can adapt our model to accommodate the step function. Let  $\alpha_\beta = \alpha_h^{SIB} - \alpha_l^{SIB}$  be the corresponding power of the incentive, similar conceptually to  $\beta$  in the linear contract model, then we can rewrite T as:

$$T = \begin{cases} \alpha_l^{SIB} + \alpha_\beta & \text{if } B > \tilde{B} \\ \alpha_l^{SIB} & \text{if } B \leq \tilde{B} \end{cases}$$

Let  $\Pi(\tilde{B}|\mathbf{i}, \mathbf{e})$  be the cumulative density function (cdf) of the probability distribution function (pdf)  $\pi(B|\mathbf{i}, \mathbf{e})$  evaluated at  $\tilde{B}$ , such that  $\Pi(\tilde{B}|\mathbf{i}, \mathbf{e})$  represents the probability that  $B \leq \tilde{B}$  for a given level of quality enhancing and quality shading effort. The expected value of the transfer to the agent then can be written as:

$$E(T) = \alpha_\beta [1 - \Pi(\tilde{B}|\mathbf{i}, \mathbf{e})] + \alpha_l^{SIB}$$

The derivative of the cdf is negative,  $\Pi_i(\tilde{B}|\mathbf{i}, \mathbf{e}) < 0$ , such that a cdf given a higher  $\mathbf{i}$  stochastically dominates one with a lower  $\mathbf{i}$ ; and  $\Pi_e(\tilde{B}|\mathbf{i}, \mathbf{e}) > 0$  such that a cdf given a lower  $\mathbf{e}$  stochastically dominates one with a higher  $\mathbf{e}$ . A higher quality enhancing effort will then shift the pdf to the right increasing the probability of exceeding the threshold, and a higher quality shading effort will shift

the pdf to the left, reducing the probability of exceeding the threshold. Again, we use the first order approach, assuming that the optimum effort level of each type for the agent is single peaked:

$$\begin{aligned}
 (\mathbf{i}^{SIB}, \mathbf{e}^{SIB}, \mathbf{f}^{SIB}) = \underset{\mathbf{i}, \mathbf{e}, \mathbf{f} \geq 0}{arg \max} & \left[ EU^{SIB} = \alpha_\beta [1 - \Pi(\tilde{B}|\mathbf{i}, \mathbf{e})] + \alpha_i^{SIB} - \left[ c_0 - \delta \mathbf{i} - \gamma \mathbf{e} - \chi \mathbf{f} + \right. \right. \\
 & \left. \left. \frac{\mathbf{e}'\mathbf{e} + \mathbf{i}'\mathbf{i} + \mathbf{f}'\mathbf{f}}{2} + \frac{r(\sigma_\varepsilon^2 + \alpha_\beta^2 [\Pi(\tilde{B}|\mathbf{i}, \mathbf{e})]^2 \sigma_\eta^2)}{2} - 3\varphi \right] \right] \\
 i_j^* = & \begin{cases} -\Pi_{i_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \delta_j & \text{if } -\Pi_{i_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \delta_j \geq 0 \\ 0 & \text{if } -\Pi_{i_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \delta_j < 0 \end{cases} \\
 e_j^* = & \begin{cases} -\Pi_{e_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \gamma_j & \text{if } -\Pi_{e_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \gamma_j \geq 0 \\ 0 & \text{if } -\Pi_{e_j}(\tilde{B}|\mathbf{i}, \mathbf{e})\alpha_\beta + \gamma_j < 0 \end{cases} \\
 f_j^* = & \chi_j
 \end{aligned}$$

An optimizing agent will now set effort taking into consideration the marginal impacts of effort on the arising of a particular state and the net cost of that effort. Applying a comparable solution framework as in the linear framework, government then takes these optimum effort levels generated here as given, sets the payment for each outcomes range to solicit the optimum level of effort, then sets the threshold values to minimize the cost of compensation.<sup>34</sup> The basic intuition of our linear model then translates into the non-linear case.

#### a) SIB Investor Compensation Structure in Practice

Gustafsson-Wright et al. (2015, pp. 55-129) undertake a systematic survey of 38 SIB contracts, with their research demonstrating that in practice SIB contracts are highly diverse in structure, spanning the range from linear compensation contracts to simple threshold contracts. The *Partnering for Family Success Program* in Cuyahoga County, Ohio, a child welfare SIB aimed at keeping at-risk

<sup>34</sup> See Oyer (2000, pp. 415-416) for a related discussion in the case of a sales quotas.



children living safely with their families, for example, uses a linear incentive scheme, where the consortium is paid for any reduction in days away from the family relative to the control group. The *Duo for a Job* employment SIB in Brussels, Belgium is another example of a linear incentive contract, where any increase in employment outcomes beyond the control group leads to increased compensation, up to a maximum equivalent of principal plus and 6% return. The *Junior Code Academy* SIB in Portugal aimed at improving school outcomes in targeted communities is also (near-) linear, with compensation increasing for every percentage point over and above the outcomes in the control group based on individual testing.

Some SIBs combine a threshold requirement with a linear component as part of the payment structure, such as the anti-recidivism *Juvenile Justice Pay for Success Initiative* in Massachusetts, where payment commences when a 5.2% reduction versus the control group has been reached, then increases continuously with further reductions. Other contracts pay based on a discrete binomial per-participant outcome where compensation is based on the amount of time the successful outcome is maintained, creating a linear or near-linear dimension to a portion of payment. For example, The Manchester City Council Vulnerable Children, the Outcomes for Children Birmingham and the Essex Family Therapy child welfare SIBs all pay based on the length (in days or weeks) of successful placements, in addition to threshold-based payments based on other metrics. The *Increasing Employment and Improving Public Safety* SIB in the State of New York is similar, with successful prevention netting a per-day benefit of \$85 per participant, in addition to two threshold-based employment metrics. This quasi-linear approach may be modified by specifying an initial threshold that must be met, such as in The Chronic Individual Homeless PFS Initiative in Massachusetts where each placement must be maintained for at least a year to generate a payment, then additional compensation is based on per-day basis after one year.

While there exist a number of SIBs based on linear incentive schemes, the majority, 26 out of 38, of SIBs analyzed by Gustafsson-Wright et al. (2015, pp. 55-129) have payment structures based on

step functions with a small number of steps. One of these, the *Eleven Augsburg* employment SIB in Germany, utilizes a single metric with a single threshold, while three others, the *NYC ABLE Project for Incarcerated Youth*, the *Utah High Quality Preschool Program*, and the *One Service* anti-recidivism SIB in Peterborough, UK, utilized a single metric with between three to eight thresholds. The remaining utilize multiple metrics within a single contract to determine success payments. For example, two UK anti-homelessness SIBs, the *Street Impact* and *Thames Street ACE* SIBs, are using a total of eight metrics: six based on meeting thresholds for individual level outcomes and two based on aggregate results relative to thresholds set by government. Within each of these metrics, there ranges between one and twelve thresholds that trigger incremental compensation. Seven additional anti-homelessness SIBs, funded through the UK Fair Chance Fund, have a similar structure, with seven outcome metrics with up to four payment thresholds in each, as do 10 employment SIBs funded through the UK's Social Innovation Fund, with four metrics with up to four threshold levels each.

#### b) The Rationale of Step-function Compensation Terms

Step functions are useful when the optimum benefit generated by the contract is highly sensitive to changes in the effort level, such that deviation from the optimum effort leads to a significant drop in benefit generated (Dixit, 2002). Take for example an SIB based on early childhood education outcomes. If the child is entitled to costly special education classes if they fail a standardized assessment test, and the same test results are used to form the basis of payment under the SIB, the savings to government are not realized unless the child passes the test. In this case, setting the payment based on a threshold of a passing grade will be more efficient from the government's perspective, if focused solely on cost reduction, than a linear compensation scheme that rewarded the contractor based on increasing test scores.

Threshold-based contracts however do not provide any incentive to exert effort once the threshold is met, and if the threshold is deemed unachievable, the agent has no monetary incentive to exert any effort at all (Dixit, 2002). In the above example, if the government is only concerned with

reducing expenditures on special education, then this is not an issue: the incentive scheme aligns, and the agent will focus effort on the children that can be moved from the 'likely to fail' category to the 'likely to pass' category. If the government values outcomes equally along the entire spectrum of test scores, then the threshold payment structure may not be efficient.

As threshold-based contracts increase the number of steps in the step function, the closer they come to approximate a linear incentive function, but qualitatively at this level of analysis, the general intuition is similar in both scenarios. Assuming the fixed payment  $\alpha_i^{SIB}$  alone is insufficient to meet the agent's participation constraint, for an agent to take the contract, additional compensation will be required to offset the implications of greater effort levels being required to meet a higher threshold, plus a higher risk premium.

Some investors have called for a movement away from all-or-nothing contracts and greater variety of outcomes measurement dimensions (Ward & Lakshmanan, 2018). In addition to serve as a type diversification strategy for investors, could also serve to better address the multi-faceted objectives being sought.

### c) The Benefit of Paying Only for Results

Some SIB proponents have depicted the fact that government only pays when projects are successful under an SIB as a self-evident positive attribute of the model (Greenblat & Donovan, 2013, p. 19; Butler, Bloom & Rudd, 2013, pp. 58-59). Threshold compensation structures are the most pronounced in this regard, and are implied by some proponents such as Liebman and Feller (2014), the US Office for Social Innovation and Civic Participation (2015), and the Government of Canada (2015), who emphasize that government will not be required to release funds if results are not delivered.

By their very structure, all SIBs lead to payments based on the degree to which the objectives of the project are realized, based on a higher level of benefit generated. In the linear model, given the behavioral assumptions where agents set effort levels according to their marginal impacts, the

payment structure of the contract SIB elicits a more optimum level of effort than in the conventional or public delivery model, however the realized payment is also impacted by random shocks  $\eta$ :

$$T^{SIB}(B) = \alpha^{SIB} + \beta^{SIB}(b_0 + \mathbf{b}\mathbf{i}^* - \mathbf{d}\mathbf{e}^* + \eta)$$

In the case of negative shocks, the government would pay less; in the case of positive shocks, government would pay more. The SIB will incentivize higher quality enhancing effort levels, but the government will need to compensate the contractor for that effort along with a risk premium arising from the uncertainty involved in the realized payment. As the variance of  $\eta$  increases, a higher risk premium is required to meet the participation constraint of the agents compared to the conventional procurement scenario, reducing the likelihood that an SIB would generate a higher payoff. SIB proponents' notion that the government only pays for success is true by definition, but the idea this is necessarily optimal is not true from a cost benefit perspective, as the higher compensation to contractors and administration costs may outweigh the incremental benefit to government.

In the case that contracts are non-linear, this general argument still applies. Additional compensation will be required to offset the implications of greater effort levels being required to meet a higher threshold, plus a higher risk premium. SIB proponents' notion that the government only pays for success is still true, but governments have to pay more for it. The superiority of the SIB will again fall back to its ability to generate sufficient efficiencies to offset these and other additional costs of the model.

## VI. Conclusion

Existing analysis of SIBs highlight how a the PbR nature of SIB contracts can generate superior outcomes relative to conventional procurement by giving agents a financial stake in the outcomes of the project (Pauly & Swanson, 2017; Wong et al., 2016). Previous authors examining PPPs in infrastructure, show how such bundled contracts can also lead to improvements through better-designed projects and reductions in operating costs (Iossa & Martimort, 2015; Martimort & Pouyet,

2008). SIBs and PPPs can also have negative impacts which these SIBs model do not incorporate. Other PPPs models point out the greater incentive to quality shade in the presence of incomplete contracts (Hart, 2003; Bennett & Iossa,2006), and this complex, high stakes contracting structure often faces higher transaction and other administrative costs and the potential for monopolistic rents.

This chapter uses the above insights to generate a more balanced model, to provide an analytical framework to better understand the potential of SIBs versus more conventional service delivery contract structures. The superiority of the SIB model relies on hypothesized efficiencies being realized and being sufficient to offset any incremental costs. For a public sector decision-maker focused on the preventative potential of social programs, the decision to proceed with an SIB then depends on the SIB delivery model's efficiency-enhancing ability to offset quality shading impacts, additional financing and administration costs, contractor rents due to reduced competition, and higher contractor compensation for effort and risk, by facilitating savings through more efficient operations, higher incremental social benefit and reduction in payment required to contractors due to non-monetary reputational benefits made available from participation in project delivery.

We also suggest that these efficiency gains, if they exist, are not sourced from the ability of SIBs to bring in 'new money' for social programs, but their ability to better align incentives such that investment in quality design of the project is closer to the optimum and accounts better for lifetime total project costs. This is similar to the conclusion in the PPP literature, summarized by Engel et al. (2013):

The crisis that started in 2008 has left many countries with large budget deficits. Hence these countries may find PPPs an attractive solution to finance infrastructure projects without increasing their apparent debt burden. We have shown that this should not be a basis for choosing PPPs over conventional provision. PPPs should be favored only when they lead to efficiency gains. To ensure

this happens, PPPs should be given the same treatment in budgetary accounting than publicly provided infrastructure (p. 106).

While private finance may leverage some in-kind contributions due to corporate social responsibility effects and bring along expertise that may generate some efficiencies through increased service quality, SIBs will primarily generate 'new' financial resources to the extent that they allow the government to skirt legislated or informal budget constraints based on accounting convention. SIBs create an expected obligation, albeit a state contingent obligation, for governments to pay out the SIB liability at some point in the future. In general, the reduction in expected costs due to the state-contingent nature of the SIB will require an increase in the required transfer to the private partner to ensure participation. Government accounting of SIB liabilities should reflect this if transparency and equivalence between expected and reported financial obligations is a priority. Similarly, the identification and accrual of projected savings is recommended to verify the assumptions underlying SIBs' privileged status above other delivery frameworks, such as public delivery and conventional procurement, as evidence of these savings in practice have been questioned (Whitfield, 2015, p. 37).

As shown in Chapter Two, there is evidence to suggest that SIBs are for the most part paying back investors and investors are earning rates of returns well above the cost of government borrowing. If this is the case, one implication of our model is that for SIBs to be providing value for money to government, the quality of services being procured under the SIB model must be higher than what would be expected in the conventional case and that high quality is due to the incentive structure and bundling, as opposed to greater expected resource availability or subsidization of the model.

However, the very notion that bundling externalities exist in publicly funded social service delivery, that can be exploited by incentive contracts, is a tenuous claim. The incentive theory model used above abstracts away from many features of the real world publicly funded social service

delivery context that could undermine the effectiveness of rigid performance-based incentives.<sup>35</sup> Those working within the incentive theory field have noted that the unique attributes of the public sector “make inappropriate the naïve application of magic bullet solutions like competition or performance based incentives” (Dixit, 2002, p. 697). More fundamentally, it is unclear why the moral hazard problem between government and external contractors does not equally apply to relations between consortium members. In the SIB model, there is generally an intermediary organization that coordinates participation the private sector players, who would face similar principal-agent problems.<sup>36</sup> In general, there are a number of assumptions of the principal-agent model, including the zero effort expended by public servants, the effectiveness of financial incentives to induce effort, abstraction away from within-firm agency issues, and the neglect of non-pecuniary motivation, which may which may undermine the predictive power of the model, especially in social service delivery. Empirically, there is also no evidence to support the idea that SIBs are generating innovation over existing social service delivery methods,<sup>37</sup> raising doubts with respect to efficiency as a cause of SIB emergence.

Despite these challenges, we believe the model in this paper represents a useful framework for understanding the claims of proponents at the project level and provides a useful accounting framework for comparatively assessing the merits of SIB delivery versus more conventional procurement models. Public servants are being asked to pursue SIBs, and the analytical approach here can inform an objective assessment of the benefits of SIBs versus alternative procurement models. However, to explain the emergence of SIBs, we suggest a more robust political economy approach is required.

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<sup>35</sup> See Dixit (2002) and Chapter 3 for additional discussion.

<sup>36</sup> See Chang (2003, pp. 208-238) who makes this point for privatization more broadly, and Chapter 3 for further elaboration of this point.

<sup>37</sup> See Chapter 3.





# Part C: The Political Economy of SIBs

# Chapter 5: PRIVATE INSTITUTIONAL PARTICIPANTS IN SIBS

## Introduction

This chapter presents some basic empirics on the organizational partners in Impact Bond projects, and examines the roles, motivations, and changing contexts of operation and constraints faced by these stakeholders. In the previous chapter we explored an approach that focussed on the efficiency-enhancing potential of SIBs. While reference was made to Corporate-Social Responsibility (CSR) effects on the decisions of private agents, this was treated as an alternative form of compensation to the firm. The orthodox model presented then relied on primarily typical neoclassical assumptions regarding the firm as a unitary entity and self-regarding behavior of agents participating on SIBs, while incorporating some insights from approaches in the new institutionalist tradition including contract theory, transaction cost and property rights approaches. Fundamentally the model relied upon agent effort, including that of designers, financiers, and service providers, responding positively to greater pecuniary compensation.

We suggest here that to evaluate SIBs as a publicly funded social service delivery model requires a more sophisticated understanding of what motivates the actions and behavior of the lead institutional players involved and their workers, and how their decisions are influenced by organizational structural characteristics. Understanding what motivates individuals and organizations involved, including their aims and objectives, can help us predict how they will respond to the change in incentive structure when moving from conventional procurement to an SIB model.

This chapter highlights how more empirically-grounded theories of individual and organizational

behavior, drawn from a more heterodox institutionalist approach, that recognizes the importance of altruistic motivation, the centrality of reciprocity, and individuals as socially embedded, can help explain the observed challenges faced by simple incentive-based schemes highlighted in Chapter 4. We then use this framework to briefly examine how the SIB model impacts the sustainability and reproduction of stakeholder organizations more broadly over time, and how their behavior may adapt. We rely on an approach to modeling cooperative behavior based on the notion of *strong reciprocity*, a framework that is well suited to this task as it embeds how individual norms of behavior may change in response to policy shifts.

On the private partner side of the SIB relation, one important distinction that helps frame and organize stakeholders based on behavioral norms is non-profit and for-profit corporate forms, both with respect to investors and service providers. A major component of this chapter is dedicated to delineating the differences between these forms of operation. Within this for-profit/non-profit dichotomy, it is argued that the high prevalence of non-profit stakeholders as social service delivery and the attraction of altruistically motivated workers, executives, and directors to the NPO sector may undermine the effectiveness of Pay by Results (PbR) contracting (François & Vlassopoulos, 2008; Lagarde, 2013). If non-profit actors are more likely to intrinsically value outcomes and share a collective identity and commitment to an organizational mission based on some altruistic social purpose, PbR may not improve efforts of these agents, and may undermine or crowd out intrinsic motivation by signaling a lack of trust and faith in the professionalism and integrity of non-profit workers.<sup>1</sup>

PbR has been defended in the non-profit context by noting that non-profit agents may respond positively to PbR if success under a PbR contract leads to an increase in resources going towards

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<sup>1</sup> Bénabou & Tirole (2003, p. 490) for example make this case for workers more generally. See Fehr & Gächter (2002b) who show in experimental settings that incentive contracts lead to significant crowding out to the point where “contracts providing explicit performance incentives are on average less efficient than fixed price contracts that do not provide any performance incentives at all” (p. 1).

client services they intrinsically value (Courty & Marschke, 2011b, pp. 71-72). If the incentive generated by this increase in resources is sufficient to offset any crowding out effects of PbR, then the net benefit for clients may increase under PbR. The SIB payment structure however is not a typical PbR structure. SIBs do not usually pay social service providers by results, and therefore service delivery NPOs are not the beneficiaries of the increased resources. At face value this further weakens the case for the SIB model relative to conventional procurement, particularly if intrinsically motivated social service workers interpret their efforts in meeting targets as primarily enhancing the private payouts to investors as opposed to enhancing the quantity and quality of service provided to clients more broadly. Alternatively, if funders are viewed as part of a larger community of like-minded organizations committed to mission-based service provision, the increased resources incentive may remain intact.

NPOs and their workers however may not be driven only by altruistic motivation to see their clients receive quality services. These workers may also have a preference, for example, to be personally engaged in delivering these services. For NPO workers, there is an opportunity cost to losing access to this in addition to employment income, and NPOs may need to rely on SIBs from an organizational sustainability perspective if traditional funding sources are increasingly restrained. NPOs and their staff then may still value SIBs. Additionally, NPOs and their staff may value process fairness and expect others to interact with them based on an assumption that the organization and its staff operate with a high degree of probity and integrity.

In this framework, the effectiveness of the SIB model will hinge on the relative strength of three factors: (1) the degree to which SIBs help the individual organization secure resources to do their work that they intrinsically value undertaking; (2) the extent that SIBs generate new resources for services for needy targeted populations overall; and (3) the extent that non-profit workers interpret the motivations of outcome funders and investors as paternalistic and dismissive of their work ethic

or altruistic identities. We categorize these as relating to *participation impacts*, *outcome fairness*, and *process fairness*, respectively, with NPO staff as valuing participation and these two types of fairness.

If NPO organizations and workers see SIBs as a good-faith, cooperative measure to support more effective service delivery and better outcomes for more clients, and generate incremental productive resources (financial and in-kind) for their organization and social service delivery they value as a whole, SIBs will likely not crowd out quality-enhancing effort by service workers and may even enhance them. Alternatively, if SIBs are seen as a paternalistic model that undermines the integrity of non-profit workers and organizations, and reduces available resources through payouts to private for-profit investors and higher administration and transaction costs, quality enhancing effort will likely decline, especially if the organization into directly benefit from SIB financing. In the latter case, SIBs then face an even greater challenge from an efficiency perspective, with the model having to rely fully on the newly solicited effort of financiers to offset this loss and other incremental costs of the SIB model. Actual experience with the model will also likely impact perception, if there is a divergence with respect to the promise relative to the reality of operating an SIB.

The above framework generates a number of problematic predictions for the SIB model overtime. SIBs here are likely to lead to the displacement of intrinsically motivate non-profits who have a comparative advantage in delivering high-quality social services at a relatively low cost, while privileging low-quality higher cost for-profit providers. Within the NPO sectors we will see a similar shift, away from non-profit community based organization that prioritize advocacy in addition to service delivery towards larger and conservative service delivery NPOs.

This chapter proceeds as follows: Section I presents new data on the private partner stakeholder organizations in SIBs, highlighting the high participation of NPOs, and briefly reviews survey and case study data on their motivations for participating. Section II elaborates on the established theory of the non-profit corporate form, emphasizing the centrality of altruism and intrinsic motivation, and

also summarizes some recent trends in non-profit and social service delivery. Section III provides a selective review of the treatment of altruism and reciprocity in economics, settling on the notion of *strong reciprocity* as our analytical framework for predicting the implications of the SIB model for social service delivery. Section IV outlines the implications of strong reciprocity and high NPO participation for SIB design, and based on this recommends an SIB model financed by charitable foundations or at low interest rates with targets set in partnership with service agents as being the most promising form of the model, based on an assumption that NPO service delivery agents have an affinity with non-profit investors. Section V concludes.

## I. The Institutional Participants in SIBs

There are several stakeholder groups in SIBs, including: (1) the government and public agencies, including elected officials, civil servants, and other workers employed by government; (2) investors and other funders in SIBs, including for-profit investors and non-profit foundations; (3) private for-profit and non-profit service delivery agencies, including those delivering social services, those evaluating the intervention, and those coordinating and/or providing technical assistance on SIB projects; (4) the clients served by the SIB funded intervention; and (5) and the public at large (Callan, Law & Mendonca, 2012, p. 7). Not all of these stakeholder groups will likely be involved or consulted in the negotiation or design of an SIB - that being generally limited to the government, intermediary and investors, with those involved in negotiations more likely to have their interests best represented (Maier & Meyer, 2017, p. 3). The key relations however that are integral for driving the efficiencies proclaimed by the model are driven through relationships with the service provider. We therefore focus our attention primarily on these three groups: government, investors, and service providers, including intermediaries and evaluators.

This section presents some basic data on institutional private participants in Impact Bond (IB) projects, including both 100 SIB projects and six Development Impact Bond projects, organized by the role of the stakeholder in the IB projects. Data on IB participant organizations was compiled by initially consulting existing databases and reports, including Gustafsson-Wright, Gardiner and Putcha (2015), Nonprofit Finance Fund (2017), and primarily Social Finance (2018). Data from these sources were further supplemented by a review of stakeholder websites and documentation published by project proponents. Table 10 presents data on the stakeholder organizations participating in SIBs as of January 2018, including outcome funders, investors, service providers, intermediaries, evaluators and technical assistance providers, but excluding law firms providing legal services.<sup>2</sup> Individual organizations participating in multiple SIBs are counted for each SIB in which they have participated. With respect to outcome funders, as expected based on our definition of SIBs, the vast majority, 93%, are government entities.<sup>3</sup> Of these government entities, just under 50% of them are federal or national governments and approximately 37% are local/municipal governments. State or provincial governments make up approximately 13%, while just over 1% are international government entities.<sup>4</sup>

For all the other categories of participants, private non-profit organizations are the most numerous organizations, with the exception of evaluators.<sup>5</sup> They make up more than two-thirds of

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<sup>2</sup> While we did identify 35 cases of named law firms who provided legal services on projects, this information was not consistently reported, being only commonly reported in US SIBs. Each project would generally require legal services to prepare and review contracts for each participating party. Legal firms providing other services, such as the role of intermediary, are included in the presented data. If organizations were both investors and service providers, they were counted twice, however if an organization played the role of intermediary in addition to another role, they were not counted as an intermediary. Similarly, organizations were not counted as technical assistance providers or evaluators if they filled an alternative role. For example, outcomes funders were often explicitly identified as the evaluators. Organizations identified as technical assistance providers and evaluators were only counted as evaluators.

<sup>3</sup> Of the 12 outcome funders that are not government entities: five are foundations supporting DIBs; three are foundations pairing with government outcome payments for projects in the UK, US and the Netherlands, where in the latter two cases the organization is playing an additional leading role; two are public post-secondary education institutions; and two are health insurers in healthcare SIBs— one non-profit in Israel and one for-profit in the Netherlands. This latter case is the only identified example of an SIB with outcome payments fully paid by a private for-profit entity, in this case the De Amersfoortse insurance company. See ABN AMRO (2017) for more details on this project.

<sup>4</sup> In federalist countries where the SIB model has been implemented, it has generally been at the state or provincial level of government that has issued SIBs, whereas in more centralized government systems it has been other levels of government taking the lead (Dear et al., 2016, p. 46).

<sup>5</sup> Investor organizations were classified as for-profit if they paid out returns to individuals or for-profit private investors. All other organizations were classified based on their incorporation status. Organizations were classified as non-profit primarily from information

service delivery providers, just over two-thirds of intermediaries and technical assistance providers, and 58% of investors. Of all non-profits participating, 77% were identified as charitable organizations. Overall, 51% of institutional participants were identified as non-profit, and an additional 22% were public-sector organizations. Given the large role of non-profit delivery, we examine the rationale of non-profit sector relative to conventional private sector delivery of services below in Section II.

Role	#	Total %	% Public	% Non-profit	% For-profit	% Unknown
Evaluator	41	5%	2%	46%	46%	5%
Intermediary	71	8%	0%	69%	27%	4%
Investor	332	40%	4%	57%	38%	1%
Outcome funder	164	20%	93%	7%	1%	0%
Social Service Provider	199	24%	7%	71%	19%	3%
Technical Assistance	30	4%	0%	67%	30%	3%
<b>Total</b>	<b>837</b>	<b>100</b>	<b>22%</b>	<b>51%</b>	<b>25%</b>	<b>2%</b>

This data reveals a few interesting facts relative to the standard SIB narrative. First, despite the emphasis on SIBs attracting new for-profit investment to SIBs, the majority of financiers are traditional non-profit organizations, primarily foundations, who have a long history of supporting social service delivery on a charitable basis. Secondly, despite the assumption that social service providers involved are generally non-profit, a significant number of for-profit providers are being

obtained from organization websites. For Australia, Canada, the UK, and the US this was a relatively straight-forward task as corporate form is aligned with tax treatment. In the US, non-profits generally post their financial statement and IRS Form 990 which clearly identify the non-profit structure. In the UK, corporations typically list their company status in the footer of their webpage, identifying their corporate status as a registered charity, with their respective registration numbers. Similarly, in Canada and Australia, non-profit status was generally straightforwardly determined based on disclosed information. Organizations in continental Europe and Asia were more challenging to classify, partially due to different website disclosure norms and partially due to the fact that in some countries, such as Germany, corporate form is distinct from tax treatment and whether an organization is operating in the public benefit. Where non-profit and charitable status were not explicitly stated, organizational descriptors and characteristics were reviewed to classify the organization. For example, if an organization accepted donations that qualified for a tax credit, organizations were classified as non-profit (and charitable). Similarly, if organizations paid out dividends to investors, referred to shareholders, and had other characteristics that indicated for-profit status, they were classified as such. In some cases there was deemed insufficient information to make such a classification and the status was recorded as unknown.



engaged. In particular, 46% of evaluators are for profit entities and include well established financial industry players including Deloitte, EY (Ernst and Young) and KPMG.

#### a) Service Provider Motivation

Under an SIB, the delivery of social services to the target client group is undertaken nearly exclusively by private service delivery agents as opposed to public sector providers, but may occasionally include arms-length public sector entities such as schools.<sup>6</sup> Surveys of service providers indicate several motivational factors for their participation in SIB projects that reflect a combination of concerns. In Gustafsson-Wright et al.'s (2015) survey of service providers, the number one reason indicated for participation in SIBs was the "opportunity to scale up intervention that works" (p. 25), while the second was to generate social returns and achieve outcomes, suggesting that intrinsic motivations based on non-self-regarding preferences were driving factors. The associated flexibility of outcomes-based contracts with the potential for innovation and testing new models was also identified by service providers as an advantage, but through their interviews they also identified funding as a driver, specifically longer-term funding and support for preventative interventions. Ronicle, Fox & Stanworth (2016), in their review of UK projects supported by the Commissioning Better Outcomes Fund, found that increased and longer-term funding was the primary motivation of service providers. Here, access to additional revenues helping to maintain the sustainability and continued existence of their organizations, particularly given the funding context of fiscal restraint and austerity, was emphasized. Ronicle, Fox & Stanworth (2016) also found support for the model based upon the focus on outcomes and how the PbR structure and evaluation allowed them to convincingly demonstrate the positive impacts of their organizations as well as improve operations. Being part of a funding structure that focuses on outcomes appears for some organizations to be preferable to service providers relative to what may appear as rationing or arbitrary decisions

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<sup>6</sup> In one exceptional case, the Swedish SKL Mission Mental Health - Health Navigator SIB, all service provision was undertaken by a public-sector entity.

regarding funding in the conventional case. The idea that funding constraints are driving participation was also identified by Heinrich and Kabourek (2018) in their interviews with US stakeholders pursuing PfS funding for preschool interventions. Unlike Ronicle et al. however, their interviews reveal a general pessimism with respect to the capacity of the SIB model to generate direct auxiliary benefits overtime, although many references the capability strengthening it generated with respect to “aligning program goals with longer-term outcome measures, developing rigorous evaluation methodologies, and attempting financial modeling of program benefits and costs” (p.26).

A successful demonstration of outcome achievement may also help organizations build future support and scale their outcomes in the future (Liebman & Sellman, 2013, p. 9). Early success with the SIB tool may position the organization as a leader in a growing field, and they may benefit from early subsidized investments in project management and capacity building in SIB service delivery. All these findings echo previous research examining why non-profits may seek out participation in PbR contracts more generally, which highlights reputational benefits and increased resources (Courty & Marschke, 2011b, pp. 71-72).

Several risks have also been identified for individual service providers participating in SIBs despite their payment not being tied directly to outcomes. Participating in an SIB and failing to meet targets could cause significant reputational damage to an organization (Callanan & Law, 2013, p. 79; Fraser, Tan, Lagarde & Mays, 2018, p. 12, Giantris & Piakiewicz, 2013). The service provider also may end up with minimal new flexibility to pursue innovative solutions of its choosing, with any new autonomy from the state usurped by the intermediary or investors who may have their own conflicting prescription with respect to how service should be delivered (Edmiston & Nicholls, 2018; Fraser, Tan, Lagarde & Mays, 2018).<sup>7</sup>

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<sup>7</sup> In some cases the involvement of investors has taken a form that could be deemed intrusive. For example, in at least one SIB, investors have become involved in the governance of organization at the board level (Thames Reach, 2015).

## b) Investor Motivation

The use of private capital to finance project operation is a defining feature of SIBs, however, the sources of that private capital and the institutional investors within these projects are not homogeneous. Investors span the range of philanthropic and more traditional private equity types and motivations, with varying weight placed on the relative importance of private financial returns versus achieving socially beneficial objectives on their own merit (Edmiston & Nicholls, 2018). Investors are attracted to the model, given the opportunity to generate a financial return and reutilize investments while simultaneously supporting socially beneficial projects (Fraser, Tan, Lagarde & Mays, 2018, p.10; Mulgan et al., 2011, p. 16; Social Finance, 2011, p. 4). The demand for social returns may be part of the organizational mission, the preferences of its leadership, or be driven by demands from individual customers or donors. Surveys of investors in SIB projects have found that a combination of social and financial returns, the opportunity to participate in an innovative financing model, and the opportunity to redeploy contributions were important for SIB investor participation (Gustafsson-Wright et al., 2015, p. 25; MaRS & Deloitte, 2013). Survey respondents also noted that gaining public recognition through their participation in the SIB was another motivating factor, support the idea that CSR is driving participation, with institutional investors who raise capital from clients noting that customer demand was also a factor (Gustafsson-Wright et al., 2015, p. 26). Investors and financial institutions may also seek out SIBs to meet government requirements for social investment, for example under the Community Reinvestment Act in the US (Godeke, 2013; Jackson 2013).

Given the risk of non-repayment in SIBs, the weight and priority given to social impact relative to financial return will influence the degree to which any individual stakeholder values the opportunity to invest in an SIB. The sources of the funding within an organization will also be an important factor. While non-profit investors, i.e. charitable foundations, and for-profit investors are quite distinct in their corporate forms and *raison d'être*, they share some similarities in the potential internal sources

for SIB investment. Both financial corporations and foundations invest resources through markets to generate purely financial returns. For financial industry stakeholders this is the core of their business, to generate profits from lending, investment, and trading. Out of the profits generated from this activity, financial corporations may choose to donate a portion to charitable causes, possibly through the establishment of their own corporate foundation. Charitable foundations also engage in these two activities, but the emphasis is reversed. Foundations are established to distribute grant funds to charitable causes, but they also often invest endowments based on generating financial rates of return on their investments. These are sometimes composed of low-risk program related investments, where funds are lent to social service projects with that have market based revenue sources sufficient to repay the loan over time (Ragin & Palandjian, 2013). The main activities of charities however focus on allocating donations to projects, particularly given disbursement requirements, in for example the US, which reinforces their historical appetite for more disbursements to untested but potentially innovative programs (Kippy, 2013). Both charities and traditional investors then engage in both philanthropic and revenue generating activity, but to different extents.

The expectations of an investor in an SIB and the value of such an opportunity is going to depend on the source of and motivation behind the funds, which will inform the risk/reward mix the investor is willing to accept (Maier & Meyer, 2017). If the source of the contribution is coming from a place of charity, and the investor values the funded program for its social benefit production or CSR, the opportunity to recover funds based on government outcomes payments is a clear benefit, as it provides the investors with the opportunity to recoup the donation and redeploy the funds.<sup>8</sup> In this case, where the funds are coming from a place of charity, investors are then more likely to accept

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<sup>8</sup> This assumes that the relevant public stakeholders who are responding favorably to the CSR cannot or do not devalue the SIB investment now that it may be repaid because it is less charitable than a grant. Given the complexity of SIBs to, for example, a casual consumer of the firm's services, this may be a realistic assumption, but savvy consumers who value CSR may discount the SIB.

higher degrees of risk. The opposite is the case when funding sources are committed based on their ability to generate financial returns, where risk tolerance would be lower.<sup>9</sup> In Appendix F, we explore in greater detail the relevance of socially responsible investment and other related concepts as driving factors for the participation of investors primarily motivated by financial returns.<sup>10</sup>

Research on the contributions from foundations indicates that program-related investment sources, as opposed to grant funding sources, are being used to invest in SIBs (Gustafsson-Wright et al., 2015, p. 25). Some studies have found financial risk a top concern with respect to participating in SIBs, with investors indicating some guarantees are likely required to secure their participation in addition to an expecting a market rate of return (MaRS & Deloitte, 2013). In general, this suggests a relatively low tolerance for risk from private investors, both of the non-profit and for-profit variety. In practice in the United States, it has been the non-profit participants who have assumed subordinate positions on many projects to secure the participation of for-profit investors (Dear et al., 2016, p. 76; Nonprofit Finance Fund, 2017), a model that has been suggested as a necessity for the SIB model to proceed more generally (Liebman & Sellman, 2013). As analysed in Chapter 2, projects appear to be delivering both moderate financial returns and relatively low risk of repayment, although this is based on relatively limited available data.

### c) Intermediaries, Evaluators and Technical Assistance Providers

Two private partner roles in the SIB that can be considered newcomers to social service delivery relative to the conventional model are the intermediary and evaluator (Maier & Meyer, 2017). Some investors have expressed a preference for SIB projects facilitated by an intermediary (MaRS and Deloitte, 2014), and others have argued that the intermediary in an SIB “plays perhaps the most

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<sup>9</sup> Some, such as Burland (2012) have argued that SIBs bring together, from an investor’s perspective, the worst of both equity and debt, with SIBs facing limited returns and high risk of non-repayment. This would imply a heavy reliance on charitable motives and in-kind CSR compensation of investors to offset these financial disadvantages. However, based on our data reviewed in Chapter 2, this did not continue to be the case over time, and likely was a questionable assertion in the first place, even for the earliest SIBs.

<sup>10</sup> See also Chapter 4 for background on the notion of CSR.

important role” (Humphries, 2014, p. 7), however, given that not all SIBs have separate intermediaries, it is questionable that this is the case. Proponents that have served as an intermediary have argued forcefully for their benefit as well as for specialized technical assistance more broadly (Dear et al., 2016 p. 57; Fraser, Tan, Lagarde & Mays, 2018, p. 11). The intermediary role in an SIB is well-suited to be filled by either a for-profit corporation specializing in finance and management, or a specialized non-profit agency dedicated to these type of social investment structures.

Based on our review, 71 of the IB projects employed an independent intermediary that was not already involved in the project as a service provider, outcome funder or investor. Of these 71 projects, just under 70% of those were non-profits, and 27% were for profits. Unlike social service providers, which were tied to a particular geographic location and generally did not participate in multiple projects, several intermediaries and technical assistance providers were often involved in numerous projects. Social Finance was the intermediary in the largest number of projects, leading 17 of the projects.<sup>11</sup> Other organizations that are explicitly special purpose SIB/PfS organizations or appear to be developing a niche in SIBs and have participated in multiple IB projects include Kois Invest (international), Laboratório de Investimento Social (Portugal), Numbers4Good (UK), Quantified Ventures (US), Sorenson Impact Centre (US), Third Sector Capital Partners (US), and the Triodos Bank (UK). Several of these organizations have also acted on other SIB projects solely as technical assistance providers.

In a survey of intermediary stakeholders and their motivations for participation in SIBs, the priorities identified included the ability to test innovative solutions to social problems and the focus on outcomes (Gustafson-Wright et al., 2015, p. 25). Survey respondents also noted that they had left careers in more traditional financial services. It remains to be determined if the motivations of intermediaries turn inward towards both the opportunities to generate revenue and sustainability,

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<sup>11</sup> Social Finance was the coordinator of the first SIB and is the leading proponent organization of SIBs globally, with national organizations in the UK, US and Israel. For more information see Chapter 2.

as per other service providers, as the organizations become more entrenched over time. Some have suggested that intermediaries, along with evaluators, have a clear vested interest in seeing SIBs succeed, and in the case of for-profit entities, have donated services in anticipation of a growing market for paid service (Maier & Meyer, 2017, p. 5; Whitfield, 2017).

Evaluators have the highest proportion of participants coming from the for-profit private sectors. Private for-profit companies that have acted as evaluator for multiple IB projects include the large multinationals Deloitte, Ernst & Young, KPMG, and Ecorys, a research consulting firm based out of the UK. With respect to technical assistance providers, the single largest player that did not hold other roles in SIB projects is the Harvard Kennedy School Government Assistance Lab, previously known as the SIB Lab, which has aided on 10 US SIB/PfS projects. While only 30% of non-intermediary technical assistance providers on projects are for-profit, the vast majority are financial sector firms focussing on accounting services or wealth management, including banks.

## II. Service Providers: The Significance of the Non-Profit Form

Above we noted the high prevalence of the non-profit corporate form of service providers in SIBs, and how the source of funding, when coming from a charitable or non-profit source, can impact the expectations of return and tolerance of risk and are likely to drive behavioural motivations. To better understand the implications of non-profit versus for profit corporate forms, this section reviews some recent developments in the NPO sector and mainstream economic perspectives on the rationale of the non-profit corporate form, including the underlying importance assigned to altruism and non-pecuniary motivations.

## a) Evolution of non-profit Social Service Delivery

The corporate constitution of a service delivery agent as either for-profit or non-profit will likely alter the balance of motivations leading to participation in an SIB. Non-profit and for-profit service providers face different operating contexts and constraints. For-profits will often be larger organizations, and given their ability to generate and extract a private fiscal surplus from transactions, and their greater emphasis on this, generally have more working capital and access to credit, leading to greater willingness to undertake risk; Non-profits on the other hand are often restrained and committed to fulfilling charitable or social mandates, and are more risk averse, and more credit and capital constrained (Morse, 2015, pp. 24-26). Non-profits then are more likely to benefit from the external finance provided under an SIB relative to a standard PbR contract.

NPOs have faced variations in government policy that have affected the scale of their participation in social service delivery. In many countries, increasing investment as part of the more interventionist and activist state led to a significant increase in the size of the NPO sector. For example, in the US, average annual federal and state spending on NPOs increasing by 6.3 annually on average from 1965 to 1980 (Salamon, 2015, p. 31). This fell drastically in the subsequent decade to 1.9% growth. While this partially recovered to 3.2% in the 1990 to 2007 period, the subsequent recessionary period again saw it reduced, to 2.3% annually on average (Salamon, 2015, p. 31). The overall trend however has been one of growth, a pattern that appears to be replicated in a number of advanced economies, based on the limited data available (Anheier & Salamon, 2006, pp. 99-100).

Historically in the US, contracted social service work had been primarily delivered by the non-profit sector with government support through grants, but non-profit organizations have faced a drastically changing landscape and scope and scale of operations over the neoliberal era. Service purchase agreements between governments and private sector non-profit social service agencies have existed for centuries (Wedel, 1976), but over time these agreements have become more prevalent and are a growing share of non-profit agency activity relative to grants (Ascoli & Ranci,



2002; Carmel & Harlock, 2008; van Slyke, 2003). The increased reliance on service purchase agreements has led to a greater emphasis on reporting and accountability to government funders, demanding greater administrative work by NPOs (Lipsky & Smith, 1989-90; McGregor-Lowndes & Ryan, 2009). This was part of the broader privatization movement that took place in the 1990s and 2000s, with increasing delivery of government services through non-profit third-parties, implemented with the objectives of generating cost saving, state workforce reductions, and increased operational flexibility within government (Auger, 1999; Hall & Reed, 1998; van Slyke, 2003). The result has been government funding now making up a significant portion of revenue for non-profit agencies.<sup>12</sup> These changes have compromised the independence of the NPO sector and restrained its advocacy role, while concurrently imposing greater administrative burden (Evans, Richmond & Shields, 2005). Given the integral nature of demonstrating results under the SIB model, outcome-related administrative accountability requirements will likely increase even further, unless an equivalent reduction in output-based reporting takes place within the model.

The NPO sector has also seen other challenges through increased competition from private sector providers. Despite popular perception, the non-profit sector is heavily reliant on fees revenue. For example, in the United States in 2007 “non-profit service and expressive organizations” fees made up just under 56% of the revenue of these organizations (Salamon, 2015, p. 13). In many cases the NPO sector may also be in competition with for profit providers. For example, in the United States, in the late 1980s the non-profit sector saw its market share eroded by the entry of for-profit providers. However, in 1987, non-profits still had a greater share of service provision with the exception of child care, clinics and home health, and nursing home care (Salamon, 1993). Between 1997 and 2013, a number of organization types, particularly in the healthcare sector but also in other social service sectors, have seen encroachment of private service providers, with the NPO sector losing market

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<sup>12</sup> For example, in 2011, public charities, which accounted for greater than 75 per cent of the \$1.59 trillion in overall revenues of the US non-profit sector, received 23.2 per cent of its revenue from governments for service provision, and another 9.5 per cent of revenue through government grants (Pettijohn, 2013b, p. 3).

share (Salamon, 2015, pp. 40-42). This has been partially due to a shift in government policy to tax expenditures as opposed to direct funding of providers, with for profit entities better placed to compete for customers and gain market share (pp. 35-37). At the same time, non-profits more generally have become increasingly entrepreneurial in a number of sectors, becoming more reliant on market sourced revenue as grant-based funding has becoming increasingly competitive and demanding (Dees, 1998a).

## b) Economic theory of the non-profit form

The defining feature of the non-profit organization (NPO) is its constitution as a non-share capital corporation and the inability of its owners to financially profit from the organization. A *nondistribution constraint* prohibits the payment of monetary dividends to its directors (Hansmann, 1980, p. 838). Additionally, a *fair compensation constraint* restricts the salaries of executives and staff (Steinberg, 2006, p. 118). The non-profit organization then is a corporate form that explicitly delinks pecuniary compensation for the owners of the firm from the achievement of objectives (Weisbrod, 1989, p. 542). NPOs are not restricted in generating 'profits' in the sense that they can accumulate revenues greater than their operating costs, but these must be reinvested or maintained within the organization, and the property rights of the firm are limited with respect to the liquidation and redeployment of assets (Steinberg, 2006). In exchange for all of these governance restrictions, non-profits are generally exempt from corporate income tax and may be subsidized in other manners (Weisbrod, 1988, p. 14).

### *Demand side advantages*

One rationale for utilizing non-profit form is based on how it "explicitly divorces rewards from the easily measured aspects of performance when those measures do not accurately reflect the quality of output" (Weisbrod, 1989, p. 542). In cases where benefits have public good characteristics and there is high potential for consumers to be taken advantage of due to significant asymmetric

information problems, non-profit forms may be superior (p. 545). Non-profit production of goods and services then may emerge when the quality of the product or service is difficult to discern by the supporter/client, creating the incentive for a for-profit firm to exploit information asymmetries by underinvesting in quality or more generally not delivering on the purchase (Hansmann, 1980, p. 844; Glaeser & Shleifer, 2001, p. 103). This can occur when the end receiver of the service is not the contributor, such as in the case of a redistributive charity where consumption is shared such that the good has public good characteristics, or where voluntary contributions are necessary to overcome high fixed costs and to achieve scale (Hansmann, 1980, pp. 845-851). The latter case is a form of consensual price discrimination where individuals with a high willingness to pay are more comfortable revealing their preferences given the non-profit status of the firm (Hansmann, 1981). Donors may have a specific preference with respect to how goals are achieved with the restrictions on NPOs providing donors with greater assurance that their donations are used in accordance with their wishes (Rose-Ackerman, 1996, pp. 716-717).

More concisely, there are two types of information asymmetry problems on the demand side that non-profit forms can help overcome: “underinformed consumers” and the case of the “free rider” (Weisbrod, 1988, p. 6). In both these cases the “nonprofit form... economizes on contracting and enforcement” (Hansmann, 1980, p. 852) which would be required to ensure that for-profit supplier was spending funds as intended by the contributor, resting on the “trust engendered by the non-distribution constraint” (p. 859). In practice the effectiveness of non-profits in resolving these problems is especially strong in the latter case as opposed to the former, since sectors which have large redistributive components based on donations, such as charities, education, and arts and cultural services, are often dominated by non-profit provision, whereas in sectors where the consumer is paying primarily to meet private needs, there is more likely to be competition pressure from for-profit firms, in areas such as health services (p. 863).

In the case of market failure, non-profit delivery may be preferable to government delivery in cases where: the service is demanded by a small subset of the population; the tax base does not align with the user base; a more streamlined accountability structure between users of the service and management is desirable; and the entry and exit of firms through competitive forces may be beneficial (Hansmann, 1980, p. 895). Government may also be slower to respond to emerging needs. Private non-profit delivery however faces its own limitations, including: limited resources tied to the free rider problem; the NPO sector's tendency to focus on subcomponents of the population as opposed to public needs more collectively; its decentralized and overlapping nature; its undemocratic functioning with decision-making power often resting with the well-resourced elite; and lack of professionalization (Salamon, 1987, pp. 38-42). Government intervention responds to these limitations of non-profit responses, based on the more universal nature of public services, and helps overcome inequitable and inconsistent access and inefficiencies. The for-profit sector completes what has been labeled the *three failures approach*, keeping a check on inefficiencies of the non-profit sector through "low-cost production, innovation, and attention to consumer demands" (Steinberg, 2006, p. 127).

#### *Supply side advantages*

The three failures approach focuses on demand efficiency considerations based on why consumers of the service or their stewards would prefer the non-profit form, to the neglect of supply side factors and non-efficiency explanations and motivations, including the desire of NPO founders, staff and volunteers to advocate collectively and generate social change (Steinberg, 2006). NPOs have at least two supply side advantages linked to their mission-centeredness and non-distribution constraints. First, it has been suggested that social entrepreneurs form non-profits rather than for-profits given their ideological or altruistic commitment to a particular goal or cause, with preferences as to how it should be accomplished, and the non-profit vehicle provides greater assurance that the organization will sustain commitment to the original vision (Rose-Ackerman, 1996, p. 719). that

founders will reinvest in the enterprise and its mission rather than extract value from the organization.

A second supply side benefit this also positions non-profit firms to more effectively attract and employ more productive staff. Employees with an affinity with the social objectives of the non-profit will self-select, with public service-orientated managers being drawn to employment in NPOs (Weisbrod, 1988, pp. 31-32). Workers in the non-profit sector then will be motivated by the non-pecuniary benefits of working collectively towards a purpose that they intrinsically value and providing that service at a high quality (Hansmann, 1980, pp. 875-876; pp. 899-901)<sup>13</sup>. Empirically, workers in the non-profit sector have been shown to have lower wages relative to their counterparts in other sectors and this has been rationalized in terms of the willingness of these workers to accept lower wages in exchange for participating in socially beneficial work (Preston, 1989).<sup>14</sup> Workers in the non-profit sector also have been shown to have higher overall job satisfaction relative to those in the for-profit sector that is unrelated to wage differentials and non-pecuniary benefits (Benz, 2005; Leete, 2006, pp. 165-166). The non-profit sector is also the major attractor of volunteer labour, with volunteers being driven similarly by both intrinsic motivation of contributing and seeing public benefits realized (Leete, 2006, pp. 167, 172). Non-profit organizations then may develop and entrench norms that strongly dissuade abuse and self-enrichment at the expense of the organizational mission, which may be reinforced through selective hiring practices at senior levels focussed on individuals who demonstrate attributes and commitment to charitable objectives (Hansmann, 1980, pp. 875-876). All of this leads to a more efficient and productive social service environment from a fiscal cost perspective.

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<sup>13</sup> See Heckman, Heinrich, & Smith (2011b) for a model of service provider behavior based on the assumption that service providers aim to maximize the net benefit to clients.

<sup>14</sup> This finding has been questioned and qualified, with later studies that control more heavily for industry sector and job characteristics finding that the wage differential is reduced or eliminated, however given the concentration of non-profits in particularly industries this may result in an identification problem. Given however the claims regarding higher quality service being a defining feature of non-profits, unobservable differences in employee desirability may be also a factor. See Leete (2006, pp. 162-163).

This intrinsic motivation of NPO workers is an example of *public service motivation* (PSM). This concept originated in the public administration literature but has been adopted in economics, human resource management, and other disciplines. It is the idea that individuals may demonstrate an altruistic preference for working in service of broader public interests, and there is convincing survey-based evidence of its existence (François, 2000; Perry & Vandenabeele, 2015). This literature highlights how individuals who are motivated by such factors will self-select into public service and in turn will bring intrinsically motivated effort, reducing the cost or otherwise producing public goods and services.<sup>15</sup> PSM has been used to explain public service efficiency and the failure of PbR in the public sector.<sup>16</sup> Experimental studies examining the impact of PbR payment schemes for government workers have invoked the crowding out of intrinsic motivation and PSM as a mediating factor to help explain the ineffectiveness of financial incentives to leverage effort from these workers (Belle, 2015; Belle & Cantarelli, 2014; Frey, Homberg & Osterloh, 2013).

Many of the arguments behind the notion of PSM in the public-sector context are transferable to the non-profit sector context. François and Vlassopoulos (2008) highlight that government and the non-profit sector are both strategically positioned given the lack of a residual claimant to benefit from altruistic and intrinsic motivation, particularly in the delivery of social services, and that this can negatively impact the appropriateness of high powered pecuniary incentives. They note that “pro-social behaviour” (p. 23) based on the intrinsic and altruistic motivations of leaders, managers and workers helps provide a supply side efficiency advantage of the non-profit form based on their willingness to accept lower pecuniary compensation. In the economic study of non-profits literature, this has been referenced as the “donative labor hypothesis” (Leete, 2006, pp. 161), which also

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<sup>15</sup> There is debate in this literature whether PSM and intrinsic motivation are separable and distinct, similar to the warm glow versus altruism classification of Andreoni (1989). Those arguing for separability measure the former based on self-evaluations of how pleasurable and interesting a worker finds their specific job, while the latter is based on revelations of commitment more generally to public service and others. See Belle and Cantarelli (2014) for example and discussion of this point.

<sup>16</sup> Rainey and Steinbauer (1999, pp. 5-6), for example, outline several historical examples of US public agencies that have been assessed and found highly efficient, ranging multiple sectors such as old age security, military, natural resource management, business administration, customs, and personal identification documentation. See also Chang (2003).

suggests that pay-for-performance compensation of executives would be less appropriate in the NPO sector, and wage differentials within organizations would be more condensed (p. 164).<sup>17</sup> The non-profit sector will then be supply constrained by “religious, ideological and political entrepreneurship” (Kendell, 2003, p. 3), reliant upon “the public-spirited generosity of philanthropists who feel that contributions to the commonwealth are spiritual or moral imperatives” (Robins, 2006, p. 13), as well as government distributions to the sector.

Given the preponderance of intrinsic motivation, the non-profit form paired with the contingent renewal of contracts, may be a particularly appropriate response to asymmetric information in an incomplete contracting environment, given that contingent renewal is facilitated by the formation of personalized relationships and interactions and the development of trust between the parties over repeated transactions.<sup>18</sup> Others have suggested that one may even go further given that the intrinsic motivation of non-profit actors may result in significant goal alignment with government funders seeking to maximize the social benefit of expended funds. Here, a conflict of interests with a profit maximizing agent may not exist when contracting with an NPO. Van Slyke (2006) for example argues that rather than agency theory based on a conflict of interest between stakeholders, contractual relations within and with non-profits are better understood within a *stewardship theory* framework based on aligned interests, where “long-term contractual relations are developed based on trust, reputation, collective goals, and involvement where alignment is an outcome that results from relational reciprocity” (p. 164).<sup>19</sup> We explore this idea further and formalize this finding in relation to our Chapter 4 model in the following section.

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<sup>17</sup> Not all mainstream economists rely on altruistic motivations to justify the non-profit form. Glaeser and Shleifer (2001) for example also emphasize the importance of incomplete contracts and how non-distribution constraints paired with donations will more likely lead to quality enhancement than in for-profit enterprises, highlighting how even a fully self-regarding entrepreneur may chose the non-profit form. See also Steinberg (2006) for more comprehensive review.

<sup>18</sup> Bowles & Gintis (1993) and Bowles (2004, pp. 233-266) review models of this type more generally as a solution to principal agent contracting problems.

<sup>19</sup> See also Brown and Trout (2004); Donaldson and Davis (1991) and Davis, Schoorman, and Donaldson (1997).

### III. Altruism, Intrinsic Motivation and Reciprocity

Understanding the motivations of non-profit sector labor and service within a stewardship theory framework requires going beyond the standard textbook presentation of the individual in neoclassical economics, with self-regarding individuals forming the standard. Neoclassical economics for the most part only recognizes one type of agent, the “rational egoist”, an agent who focuses only on their own material gains and this is the model of human behavior primarily found in mainstream policy analysis (Ostrom, 2005, p. 253). Heterodox economists, especially Institutional and Feminist economists, have long criticized this neglect (Folbre, 1995; Hodgson, 1993). Folbre for example puts forward three categories of alternative motivations “altruism ..., long-run reciprocity and the fulfillment of obligation or responsibility” (p. 76). She highlights the importance of these alternative motivations in explaining caring labor, which characterizes much of the work being undertaken by non-profit direct client service providers through SIBs. These schools and heterodox approaches more generally also reject the methodological individualist approach and assumption of exogenous preferences in neoclassical theory, highlighting individuals as socially embedded, operating in a structure-agent framework, with institutionally shaped preferences (Davis, 2003, pp. 108-166).<sup>20</sup> While methodological individualism is fundamental to neoclassical economics (Collander, 2000), there are however examples on the periphery incorporating altruistic behavior within a setting of exogenous preferences.

#### a) Altruism in Neoclassical and Institutional Economics

Within neoclassical economics itself, the dependence of preferences through the specification of individual utility to include the wellbeing, consumption or behavior of others are long standing, going

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<sup>20</sup> Institutionalists, for example, emphasize how the “individual is socially and institutionally constituted.... molded by cultural or institutional circumstances” (Hodgson, 2000, p. 327). See also Hodgson (1993 & 2014) and Rutherford (1995) for a summary of the ‘old’ institutionalist economics, distinguished from new institutionalist economics which is methodological individualist and based on the assumption of exogenously determined preferences (Hodgson, 1993). Some have argued that the institutionalist approach has been partially incorporated into mainstream economics (Hodgson, 2007), as mainstream economics has become more eclectic (Davis, 2007).



back to Pareto, Fisher and Marshall, and were later systematically formalized by Gary Becker (1974, pp. 1064-1065). Two distinct forms of altruism have been analysed, one towards one's close genetic relations and other close friends, and generosity more broadly (Rose-Ackerman, 1996, p. 710). Both approaches have been attempted to be construed by economists as enlightened self-interest, such that altruism may be *fitness enhancing* in that it improves the odds of survival of one's genes or more broadly one's material outcomes. Becker (1976) for example, constructs a model showing how altruists can end up with consumption equal to or higher to self-interested "egoists" (p. 822), as rational egoists will consider the effect of the altruist's generosity on them in social interactions and will support higher income for the altruist as they in turn benefit, in effect also appearing to engage in benevolent behavior. This leads to Becker's "rotten kid" (1974, p. 1080) theorem where even a purely self-regarding child maximizes utility by behaving as if they were an altruist, in a family with a parent who sufficiently values the wellbeing of other family members. Collard (1978) points out that enlightened self-interest is simply utility maximization under uncertainty and can be handled with standard economic approaches, as can the case of "reciprocity or implicit exchange" (p. 4), although he believes that true altruism is common and does exist.

Others come to similar conclusions regarding the benefits of altruistic behavior but operate from a more institutionalist/ evolutionary perspective and model individuals as norm followers with ethical commitments as opposed to from hyper-rational utility maximization.<sup>21</sup> Others, with one foot back in the neoclassical school and remaining within the utility maximizing framework, highlight the complexity of preference structures, incorporating and distinguishing between moral values and ethical considerations, in addition to self-interest. For example, Andreoni, (1989, 1990) puts forward

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<sup>21</sup> Bergstrom and Stark (1993) demonstrate how cooperators, while losing out on one-time interactions, can still prevail over time in evolutionary settings if interacting primarily with other cooperators and end up with greater rewards, although they briefly situate this approach also in a utility maximizing framework. Smith (2003) for example discusses altruism and reciprocity as efficiency enhancing institutions arising through trial and error. Gintis, Bowles, Boyd & Fehr (2005) argue there is a genetic-evolutionary disposition in the human species towards cooperation, and evolutionary group selection pressures resulted in the development of levelling institutions that minimized within-group competition to increase the likelihood of survival in inter-group competition. See also Bowles (2004, pp. 441-468) who develops an inter-group model of the evolution and survival of altruistic norms based on its enhancement of group fitness despite its individual fitness reducing character.

a “warm glow” theory of “impure altruism” (1989, p. 1447) which distinguishes between the personal enjoyment individuals experience when contributing to others, from the direct valuation of the wellbeing of others, which has generated support through experiments (Harbaugh, Mayr, & Burghart, 2007).<sup>22</sup> Alternatively, individuals may be motivated by inequality aversion (Fehr & Fishbacher, 2005; Fehr & Schmidt, 1999).

Simon (1991), whose work has been central to the modern heterodox institutionalist school, puts forward a particularly relevant theory as to the functionality of altruism in institutional settings. He suggests that unselfish behavior facilitates integration in human society, where advantages arise to non-egoist behavior due to the “docility” of altruists such that they are “tractable, manageable, and above all, teachable” (p. 35). Docility is “used to inculcate individuals with organizational pride and loyalty” (p. 36), facilitating an affinity between the individual and larger institutions, allowing the individual to intrinsically value the achievement of the collective’s identified goals. This identification of workers within organizations will reduce shirking or inattention to quality, for example (p. 41). Within this framework, organizations and government can be “highly effective” with minimal and at best indirect motivation of market forces and/or the profit motive (p. 43).

Individuals then may be intrinsically motivated as opposed to requiring external impetus to deliver high levels of effort that may not appear to directly reward the individual in a material or self-serving manner (Kreps, 1997). An attempt to introduce rewards and incentives tied to outcomes in this case may not be effective and even may be counterproductive in situations where agents view such actions as evidence of a lack of trust or low confidence in their abilities, or an indicator of the undesirability of the work (Bénabou & Tirole, 2003, p. 490). Frey (1997) emphasizes the importance

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<sup>22</sup> Sen (1977) similarly distinguishes acts of sympathy from acts of commitment, where the former can be understood as self-regarding, while the latter is based on selflessness. Margolis (1982) models individuals as having two utility functions, one that is selfish and one that is for the individual’s social group with which he or she identifies, with the value placed between the two determined by a “fair share ...principle” (pp. 36-37). Others have suggested that utility maximization is constrained by a Kantian ethical norm or duty of cooperation (See: Collard, 1978, pp. 14-15, 43-44; Laffont, 1975), or a less stringent obligation to not to free ride in a public goods scenario where others are expected to contribute (ex. Sugden, 1984).

of intrinsic motivation, and how the “price effect” (p. 20) of pecuniary reward may not outweigh this crowding out effect.<sup>23</sup>

The presence of displaceable intrinsic motivation has significant implications for the principal-agent model in the previous chapter, as highlighted by François and Vlassopolous (2008). They situate the importance of this in the social service delivery context, noting that in the case of impure altruism, corporate form is irrelevant, where in the case of pure altruism, non-profit and government delivery is advantageous given the ability to attract donated labor effort. Based on an extensive literature review, they put forward a representative utility function of an agent who is motivated by both outcomes-based altruism and intrinsic warm glow type motivation, modeled as increasing in quality-enhancing effort. Assume now in our model that an agent directly values both contributing quality-enhancing effort towards an intervention and the benefit generated such that:

$$U_j = T_j - C_j - \psi_{i_j}(i_j) + h_j(i_j) - \psi_{e_j}(e_j) - R_j + \varphi + \mu_j B$$

Where  $\mu$  is a value between 0 and 1 that weighs the value of benefit generated to the agent and  $h_j(i_j)$  represents the warm glow effect and the other variables as described in Chapter 4. In the conventional case where the service provider is paid a fixed price contract  $T_\theta^C = \alpha_\theta^C$ , the service operator will accept lower compensation as it intrinsically values outcomes.<sup>24</sup> Ignoring warm glow and just looking at pure altruism effects, the optimum levels of effort will change, with quality-enhancing effort increasing and quality-shading effort falling relative to where there is no intrinsic motivation:

<sup>23</sup> While the introduction of monetary incentives and/or controlling regulation into relationship-based transactions can lead to the crowding out of intrinsic motivation, it does not necessarily do so. Frey notes several conditions that will affect the degree to which intrinsic motivation will be crowded out (pp. 26-33, pp. 92-96). The less impersonal the exchange, the more enjoyable or interesting the task, and the greater scope for possible variation and therefore participation of the agent in how work is done, the more likely intrinsic motivation will be crowded out. Crowding out will also increase to the degree to which the intervention is: based on controlling regulation as opposed to rewards; ignores the input and specific capabilities of the individual; and is strict and rigid in imposition and enforcement.

<sup>24</sup>  $T_\theta^C$  will be reduced by  $h_{i_j}(i_j) + \mu B - \frac{r(\sigma_{\eta_j}^2 \mu_j^2)}{2}$ .

$$i_3^* = \begin{cases} \mu_3 b_3 + \delta_3 & \text{if } \mu_3 b_3 + \delta_3 \geq 0 \\ 0 & \text{if } \mu_3 b_3 + \delta_3 < 0 \end{cases}$$

$$e_3^* = \begin{cases} \gamma_3 - \mu_3 d_3 & \text{if } \gamma_3 - \mu_3 d_3 \geq 0 \\ 0 & \text{if } \gamma_3 - \mu_3 d_3 < 0 \end{cases}$$

This moves the level of effort closer to the social optimum increasing social welfare.<sup>25</sup> In the case of the introduction of payment by results for agents:

$$U_j = \alpha - C_j - \psi_{i_j}(i_j) - \psi_{e_j}(e_j) - R_j + \varphi + (\mu_j + \beta)B$$

Assume the contract is still unbundled and only the service provider is paid by results (see Appendix D part a). Optimal effort levels of the service provider/operator now become:

$$i_3^* = \begin{cases} (\mu_3 + \beta_0^{PbR})b_3 + \delta_3 & \text{if } (\mu_3 + \beta_0^{PbR})b_3 + \delta_3 \geq 0 \\ 0 & \text{if } (\mu_3 + \beta_0^{PbR})b_3 + \delta_3 < 0 \end{cases}$$

$$e_3^* = \begin{cases} \gamma_3 - (\mu_3 + \beta_0^{PbR})d_3 & \text{if } \gamma_3 - (\mu_3 + \beta_0^{PbR})d_3 \geq 0 \\ 0 & \text{if } \gamma_3 - (\mu_3 + \beta_0^{PbR})d_3 < 0 \end{cases}$$

The presence of a crowding out effect implies that  $\mu_j$  is a function of  $\beta$ , such that  $\frac{\partial \mu_3}{\partial (\beta_0^{PbR})} < 0$ . If the crowding out is complete such that

$\frac{\partial \mu_3}{\partial (\beta_0^{PbR})} = -1$  and the introduction of the payment by result incentive at the individual agent level is fully counteracted, the introduction of the incentive will have no impact on the net effort levels selected by the service provider. The payment based on outcomes however generates higher administration costs and the risk premium increases further, so overall welfare is reduced. As we move to the SIB model, as before, the bundling of components will provide the incentive to the

<sup>25</sup> Social welfare would increase by:

$$E[W^*] - E[W^C] = \left\{ \mu_3 \left( 1 - \frac{\mu_3}{2} \right) (b_3^2 + d_3^2) \mid \mu_3 b_3 + \delta_3 \geq 0; \gamma_3 - \mu_3 d_3 \geq 0 \right\} - \frac{r(\sigma_\eta^2 \mu_j^2)}{2}$$

financier and designer to exert both quality enhancing and quality shading effort, but now we are fully reliant on these efforts to generate any net benefits. To the degree that designers and financiers are also intrinsically motivated and experience crowding out, SIBs will be increasingly less advantageous.

Besley & Ghatak (2005) in the context of school quality and incentive pay for teachers, similarly adopt the assumption that agents are intrinsically motivated, but assume that motivation is conditional on the type of organization that the individual is employed with. More specifically, intrinsically motivated individuals hold a preference for a specific “mission”(p.617), which is broadly defined as to relating as to how the organization goes about accomplishing its objectives. They utilize this framework to demonstrate how this, combined with competition between organizations to delivery service and attract staff, has efficiency enhancing qualities. Staff are attracted to the organizations best aligned with their mission, minimizing quality adjusted labor costs. They also highlight the implications of funders who provide support aimed altering how organizations go about doing their work, noting that “mission changes come at a cost, since the agent... will become demotivated and the organization will become less productive” (p.626).<sup>26</sup>

Below we attempt to situate the above insights regarding intrinsic and altruistic motivations into a framework that acknowledges a preponderance of altruistic and reciprocal behavior but also accommodates the presence of some rational egoists, where policy decisions can shift behavior. We then use this framework to analyze the shift SIBs may induce.

## b) Strong Reciprocity Theory

One modern critique of the self-regarding *homo economicus* and enlightened self-interest explanations of non-self-regarding behavior that builds on the insights above and incorporates

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<sup>26</sup> See also Besley & Ghatak (2006), who build on this framework, examine more explicitly the issue of teacher pay, and highlight how incentive pay may increase productivity but can have negative equity considerations.

altruism, reciprocity and obligation as motivators of human behavior, is the theory of *strong reciprocity*. Strong reciprocity theory emphasizes that individuals have preferences over social processes and outcomes for others in addition to their own personal outcomes (Gintis, Bowles, Boyd & Fehr, 2005). Gintis et al. (2005) define strong reciprocity as “a predisposition to cooperate with others, and to punish (at personal cost, if necessary) those who violate the norms of cooperation, even if it is implausible to expect that these costs will be recovered at a later date” (p. 8). Strong reciprocity differs from typical models explaining altruism which depend on self-interest and relationships between individuals allowing for punishment to be implemented and subsequent rewards to be recouped.<sup>27</sup> It is argued that strong reciprocity is a more general notion and can be applied when agents are anonymous and only partake in one-time interactions. The theory of strong reciprocity implies that individuals are primarily “conditional co-operators” and “altruistic punishers” (p. 8). Conditional co-operators by definition are altruistic when they anticipate that the individuals they are relating with are also altruistic. Altruistic punishers will punish individuals, even at a significant net cost to themselves, if they feel that the individuals have violated what they consider the “prevalent norms of cooperation” (p. 8). Strong reciprocity highlights that it is the intention of the interacting parties that matters, as opposed to outcomes, (Bowles et al., 2005, pp. 18-19) such that this behavior is distinct from inequality aversion (Fehr & Fischbacher, 2005, p. 153). A number of experimental studies have demonstrated a high consistency of individual behavior with the strong reciprocity thesis (Carpenter, Bowles, Gintis, & Hwang, 2008; Fehr & Fischbacher, 2005; Fehr & Gächter, 2000, 2002a,b; Gintis, 2000; Gintis et al., 2005).

Based on their review of experimental studies, Fehr and Fischbacher (2005) suggest that assuming between 40% and 50% of agents are strong reciprocators and the remaining are self-interested is reasonable (p. 181). While they note that strong reciprocity is only one possible

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<sup>27</sup> These models of group “reciprocal altruism” often end up being unstable and converging to universal defection when a small number of participants chose to defect, due for example to random behavior. See Bowles (2004, pp. 441-444). For additional discussion of strong reciprocity theory see Fehr, Fischbacher, & Gächter (2002) and Brown (2000).

alternative behavioral type, they note that there is much evidence supporting the strong reciprocal type and that the presence of strong reciprocators fundamentally changes the first-best behavior of purely self-interested agents (p. 155). For example, in a sequential game where there are gains from cooperation, if a self-interested individual identifies it is engaging with a strong reciprocator, cooperating in response maximizes the selfish players payoff – a result with parallels to Becker's rotten kid theorem. The presence of strong reciprocators effectively transforms prisoner dilemma type games where self-interested agents always defect into coordination or assurance games, with threat of altruistic punishment reinforcing the mutually beneficial coordination equilibrium.

The strong reciprocity literature most relevant to SIBs are contracting model experiments based on employment relationship settings. Fehr and Fischbacher (2005) for example review this literature and the implications of strong reciprocity for the standard moral hazard model with principal setting as a compensation structure for an agent exerting quality enhancing effort. They highlight that if the relationship involves strong reciprocators, implicit contracts based on trust can outperform explicit contracts tied to effort levels (pp. 176-178). Fehr, Klein & Schmidt (2007) build on these studies and examine the standard explicit contract relative to two trust-based contracts, one where the employer pays a generous wage in advance, and a second with an implicit contract based on an optional bonus structure. They find that the implicit contract based on the bonus structure has the highest take-up rate in experimental settings and generates the highest total surplus, while the standard explicit contract model dominates the trust contract based on a high wage. This result could again help rationalize the conventional social service procurement model where a bonus could be generated through repeated selection and rents in an implicit contingent renewal relationship.

Strong reciprocity theory suggests that neoclassical economics' ignorance of the conditional co-operator and altruistic punisher aspects of human behavior has led to significant mistakes and lost opportunities when forming public policy. While some agents in any particular situation may be rational egoists, many will likely be strong reciprocators, and some may be somewhere in between.

Ostrom (2005) also highlights that the number of strong reciprocators and rational egoists however is not static: rational egoists can become strong reciprocators by learning from strong reciprocators and strong reciprocators may become discouraged and turn into rational egoists. The degree to which community members will be willing to cooperate will be influenced by the characteristic of the given policy intervention. After reviewing a variety of experimental evidence, Ostrom makes the following three generalizations. First, many people are intrinsically motivated strong reciprocators or are capable of learning to be when in repeated contact with strong reciprocators. Second, as long as strong reciprocators can identify each other they will stay strong reciprocators and will generally receive higher material rewards than rational egoists. Third, the informational networks regarding other community members are crucial in obtaining the second result, which highlights the importance of institutions which facilitate this process.

Appropriate policy design then must not only acknowledge the existence of strong reciprocators but also the degree to which policies will crowd-in or crowd-out participation. Ostrom prescribes a policy framework involving a multi-faceted approach including the participation of government, community organizations and the private sector. This framework is likely to increase the degree to which community members perceive control over the policy intervention and encourage cooperative behavior. More specifically, interventions that are deemed to be “controlling” by community members will crowd out cooperative behaviour where interventions seen as “supporting” will encourage cooperation (p. 258).<sup>28</sup>

Ostrom reviews public policy practice in the recent era and argues that a trend away from local decision-making towards a more centralized regulatory bureaucracy has emerged worldwide, with several problematic messages being conveyed to the public, including that the state expects citizens

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<sup>28</sup> See also Frey (1997, p. 18), who highlights that this determination is subjective and therefore the same action may be interpreted differently, i.e. controlling by one and supporting by another, by different individuals. This however does not imply that measures cannot be objectively evaluated as relatively more controlling or supportive, but this should be empirically informed by responses from agents.



to behave as rational egoists, which has created a self-fulfilling prophecy through the crowding out effect discussed above.<sup>29</sup> Ostrom reviews evidence regarding the effectiveness of policy frameworks designed to manage shared resource use, and from this concludes that the most effective framework is not a centralized system of regulation but a “polycentric system” of management (p. 269). Polycentric systems are composed of several semi-autonomous decision-making bodies at different levels of governance, which include public and private entities.

Bowles and Gintis (2005) build on Ostrom’s (2005) polycentric system of management and in particular focus in on community governance. After reviewing several case studies, they make the following generalizations. The first is that community governance has the ability to not just address market failures but also failures of the state to deal with several types of community level problems. In particular community governance was shown to facilitate the provision of local public goods, risk sharing, credit markets, and most relevant to SIBs, the monitoring of work effort in cooperative ventures. Bowles and Gintis point out two reasons why community governance is able to address these problems that the state or private sector cannot. The first is that in communities the likelihood of repeat interaction amongst members is high, which promotes socially beneficial behavior. Secondly, there are diminishing costs as individuals interact over time due the development of relationships and trust that reduce information asymmetries. Over time individual interactions will develop into networks which will further reduce transaction costs and further increase the benefits of socially beneficial behavior. Finally, communities are able to overcome free-rider problems by ostracizing those who engage in free-riding behavior.

Another generalization that Bowles and Gintis make is that how the distribution of property rights is assigned at the local level will contribute to whether community governance is crowded-in or crowded-out. The key argument here is that for community governance to be successful, local

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<sup>29</sup> See also Bowles and Hwang (2008).

community members need to own the rewards and consequences of their management of local issues. Also, the management and distribution of the rewards of successful cooperation must be done in a highly transparent and public manner so that the altruistic punisher mechanism can function to avert the breakdown of the cooperative process. These property right frameworks will require legal and governmental support to foster the environment necessary for community governance to be effective. Community governance therefore is a complement to rather than a replacement for competent state governance.

#### IV. Implications for SIB Implementation and Design

The strong reciprocity thesis provides a framework for assessing how SIBs will impact the delivery of social services, with both static and dynamic implications. Like the literature reviewed above on the NPO form, strong reciprocity suggests that individuals in practice are likely to be intrinsically motivated to provide a high level of work effort, particularly in a social setting related to local public good provision. This intrinsic motivation, however, can be crowded out by public policies and contract structures that undermine trust and imply that individuals will behave as rational egoists.

Even if the introduction of an SIB is seen as an unfair act, it is unclear whether, the participating NPO would respond by giving up the opportunity to participate in the SIB or by withdrawing effort. SIBs have the potential to generate improved outcomes for clients and additional resources for the NPO and the sector more broadly that the NPO sector agent identifies with. The response will depend on a variety of factors including the degree to which the SIB model is expected to generate new resources for the specific NPO or the sector with which they affiliate more broadly. Evidence suggests in bilateral experimental settings, that while strong reciprocators value equitable outcomes, the

desire to punish could take priority (Falk & Fischbacher, 2005). The adding of warm glow considerations further complicates the analysis.

The multi-faceted nature of the preferences and behavior of strong reciprocators create challenges for predicting the crowding-in or crowding-out response in any specific applied scenario. Once one determines that agents value participation, equitable outcomes and fair processes, and that individuals will engage in altruistic punishment, one must make judgements as to how these tendencies interact and are respectively valued. These issues become more challenging in our case study, as NPO participants are acting in reference to multiple partners, including the government, intermediary and investors, as well as their client base for whom they may intrinsically value servicing. Here we suggest that the relevant factors will include: *participation impacts*, the degree to which the intervention affects the ability of the NPO to participate in service delivery; *process fairness*, whether the intention of the SIB model is deemed fair or unfair, and *outcome fairness*, whether the outcome implications for client pools are deemed fair or unfair. The determination of fairness may be based on expected outcomes for either their organization or the sector more broadly or based on norms that value sovereignty and self-determination, as well as the degree to which NPO stakeholders see investors as part of a larger group of community insiders. In the remainder of this section we discuss these three factors, the implications of these contextual attributes, and based on this, put forward recommendations on how to structure SIBs. We then explore the dynamic implications and two remaining potential critiques of our analysis.

#### a) Participation Impacts

NPOs and their workers may value being personally engaged in delivering services as per the “warm glow” theory of “impure altruism” (Andreoni, 1989, p. 1447) where givers value the act of contributing to others in addition to and independent of the outcomes it generates. For paid workers, losing access to employment that provides warm glow in addition to income from this source can

generate a strong incentive for sustaining their particular organization. Also, NPOs, particularly in a context of austerity, constrained in their funding options, may need to rely on SIBs from an organizational sustainability perspective if traditional funding sources are increasingly restrained. For these reasons, NPOs and their workers may value SIBs as this allows them to access additional resources immediately and position themselves into the future by distinguishing themselves as willing to engage in innovative approaches based on new partnerships and signal their value of outcomes, further positioning themselves in a competitive funding environment.

## b) Process Fairness

If the intentions of SIBs are interpreted as punitive or paternalistic and SIBs are identified as a mechanism of control, they will more likely displace intrinsically motivated effort and spur NPO stakeholders to engage in costly reciprocal punishment. Alternatively, if SIBs are deemed supportive and complementary to the values of the NPO stakeholder, they may crowd in effort. The reference point will be important here: If NPOs are currently engaged in funding arrangements that involve a high degree of micromanagement and limited discretion for agencies, then SIBs may be seen as an improvement. If current relationships are flexible arrangements based on a partnership or stewardship approach, SIBs may be interpreted as less fair. To improve the likelihood of crowding in, governments could work with non-profit funders and service providers to collaboratively set targets with investors and the intermediary to build program metrics deemed reflective of client well-being, not just government savings. In general, a participatory approach would build on the advantages of community governance.

## c) Outcome Fairness

If NPO stakeholders value the well-being of clients intrinsically, the degree to which the SIB model leads to more or less quality adjusted support will be of direct concern and potentially of indirect concern with determining intentions for SIB implementers and fairness implications of the model. If

NPO stakeholders see SIBs as a tool that increases resources available for frontline service delivery, SIBs may crowd-in effort, and vice versa. (SIBs may be viewed as increasing total resources available by circumventing self-imposed budget constraints within government by drawing upon future cost savings due to prevention, and steps are taken to keep these resources dedicated to improving and engaging in incremental social service delivery.)

Design features that could improve the likelihood of this crowding in could include reduced rates of return to at or below the cost of government borrowing, or require investors to explicitly commit that any returns be reinvested in social service projects (Tse & Warner, 2018b). This will help provide reassurance that government is not transferring rents in the form of interest payments to the private sector investors, attract investors motivated primarily by CSR concerns, and reassure NPO stakeholders that SIBs are not diverting funds from social service delivery (Tse & Warner, 2018b). Alternatively, governments could limit investors to non-profit investors with well-regarded reputations for social and fiduciary responsibility based on a track record of supporting high performing social service delivery. The latter could require the establishment of an independent NPO to receive and reallocate outcomes payments. In general, crowding in will increase to the degree to which NPOs share an affinity with funders and believe their involvement will improve outcomes.

#### d) Design in Practice

Some SIBs have adopted the above noted measures to address process and outcomes fairness, in some cases explicitly in response to criticisms of the SIB model. For example, the Chief Executive of YMCA Scotland, Peter Crory (2013), criticized the first pilot SIB and emphasized how a subsequent SIB delivered by the Scotland YMCA “create[d] a more localised community model that would enable local relationships to grow between investor and provider and participant... [and] reject[ed] distant investors whose sole interest may be financial”. He noted that “reducing the return to investors has not removed the interest of investors” and advocated a similar model for future SIBs. In another case,

The Augsburg child welfare SIB was advertised by sponsors as being fully based on non-profit investment and very low maximum return rates, who emphasized that this model “reduces the often-legitimate concerns about profit-driven private investors” (Ruf, 2014). The South Carolina Nurse Family Partnership PFS project is also fully financed by non-profit investors who have fully committed to reinvestment of any outcome payments to expanding the program to additional clients (South Carolina Department of Health and Human Services, 2016; Tse & Warner, 2018b). The Oklahoma Women in Recovery SIB is also based nearly fully on investment from a single charitable foundation which committed to continual reinvestment in programming as outcomes payments were received (State of Oklahoma, 2017). Other projects have also emphasized that outcomes payments will be partially recycled (Third Sector Capital Partners, 2014).

Despite these examples, it does not, however, appear that the SIB model more generally is adopting these reforms. Based on our data presented in Chapter 2, low interest rate SIBs appear to be the exception, although there is significant variation. Additionally, based on our dataset, we could only identify 13 of the 100 SIB projects to date as being funded solely by non-profit investors. This highlights a high potential for crowding out of intrinsic motivation.

#### e) Dynamic Selection

Strong reciprocity theory predicts that dynamically this crowding out would affect the balance of strong reciprocators in the community relative to rational egoists, further displacing intrinsic motivation. To the extent that SIBs communicate the notion that communities are incapable of properly managing their own affairs and that all public policy must be formulated by experts and professionals, this will further crowd out altruistic behavior. SIBs may also undermine polycentric systems of governance by rewarding investors as opposed to service providers for success.

Even if the SIBs are able to shift to a reliance on non-profit finance, rely on genuine partnerships with service providers, and restrict interest rates, SIBs still may have a problematic implication for

the composition of the service provider population over time. Non-profit social service delivery agents themselves are not homogeneous. One distinction that is often made is between smaller local community-based non-profits who deliver services but also are representative of their clients and engage in advocacy, and larger service delivery organizations that are more corporatized and bureaucratic in their structure. Large-scale service-based NPOs may have little resemblance to local community-based organizations and may be more similar to for-profit organizations in how they structure their operations and their administrative capacity.<sup>30</sup> Both large scale non-profit and for-profit organizations in some countries have the scale and influence to exert pressure on government and policy in relation to their interests, which may differ relative to local organizations (Finn, 2008, p. 8). As non-profits grow, there are concerns that such growth, particularly when based on government revenues, will compromise commitment to the original mission of the organization and ability to engage in advocacy for the disadvantaged groups. There is also mixed evidence regarding the effectiveness of large NPOs relative to smaller organizations, with some studies demonstrating counter to economies of scale arguments, that smaller non-profits are no less efficient in the proportion of revenues spent on programing and administration, and are more cost effective in fundraising (van der Heijden, 2013).

It has been noted that there are relatively few organizations that can deliver large-scale service interventions and have the institutional capacity to handle the complex project management and tracking required by SIBs (Dear et al., 2016, p. 51) and that SIBs have been primarily engaging large non-profits to deliver services (Edmiston & Nicholls, 2018, p. 73). The SIB model then may lead to a marginalization of smaller community-based profits focused on providing representation of local concerns (Joy & Shields, 2013) and “challenge... the values supporting the historic ways in which

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<sup>30</sup> See Dees (1998a) for discussion of a spectrum of non-profit enterprise that spans from “purely philanthropic” to “purely commercial” (p. 60).

services have been delivered by public, non-profit and voluntary providers” (Fraser, Tan, Lagarde & Mays, 2018, p. 8).

With SIBs there are also related concerns that non-profit organizations will be driven from their missions and replaced by for-profit entities (Fraser, Tan, Lagarde & Mays, 2018, p. 9) or more corporatized non-profits. There is historical precedent for this. For example, the earlier shift to pay by results in the UK in workforce development was found to shift service delivery away from secular community based NPOs to larger religious-based organizations (Finn, 2008, p. 22). In the Netherlands, the shift to PbR contracting resulted in a shift in the type of workforce development services offered and a greater market share for for-profit entities, while in Australia community-based organizations had trouble competing (Finn, 2008, pp. 44-45). SIBs may place smaller non-profits under additional pressure in the context of increasing dependence of NPOs on government that threatens to erode the role of NPOs as civil society organizations and may further lead to organizations adapting their mission and organizational structure to secure contracts and meet externally imposed outcome targets, as opposed to meeting the multi-faceted needs of their clients (McHugh et al., 2013).

#### f) Radical Critique

The proposed set of solutions to the problematic implications of SIBs above suggests a reliance on non-profit finance, resulting in a shift of resources from public control to charitable foundation control, relative to conventional procurement. This has been argued by some as regressive relative to a model based on public funding as increasing private philanthropy has contradictory implications on socio-economic inequality, as the charitable model primarily reproduces power relations between dominant and popular classes. This critique is couched within a critical assessment of reliance on the voluntary and non-profit sectors more broadly (Roelofs, 1995), and traces its roots back to Marx and Engels’ (1994) description of philanthropists and charity in the Communist Manifesto as the



“redressing [of] social grievances, in order to secure the continued existence of bourgeois society” (p. 181).

Roelofs (2003), for example, notes that charitable foundations are reliant on and accountable to their benefactors, who are generally representative of the dominant interests in society, with foundations generally established directly by corporations or individuals who trace their wealth back to ownership rights over private corporate enterprise. In the SIB context, for example, based on our compiled data, at least 34% of non-profit investors were private individual or family foundations, and at least another 13% were corporate foundations, such that nearly half of the non-profit investors in SIBs were accountable only back to these private stakeholders, as opposed to more collectivist community foundation models, where the influence of wealthy contributors is less transparent. Roelofs reviews the historical evolution of foundations in the United States and criticism based out of the early 20<sup>th</sup> century progressive movement, that was prominent until the war period. She highlights the unaccountable and undemocratic nature of foundations and their potential to subvert democratic processes. Roelofs argues the charitable foundation model is fundamentally undemocratic, and facilitates and maintains an inequitable distribution of private wealth and power by facilitating tax avoidance through wealth transfer to trusts and foundations. The wealthy in turn exert their influence through social service delivery project selection as well a broader agenda setting through the funding of policy research.

From a critical political economy perspective, a larger non-profit service sector more broadly can also be reflective and reinforcing of regressive tendencies, indicative of class struggle outcomes in favour of “the middle class or landed political elites” while a large public service sector is more reflective of greater influence of “labour movements and allied forces” (Kendell, 2003, p. 4; Salamon & Anheier, 1998). Within this framework a large charitable sector can have a dissipating effect on social movements advocating for more fundamental change aimed at addressing the root causes of high socioeconomic inequality. It does this through various channels, including the employment of

individuals who would otherwise be focussed on more radical social change, and the employment of labor displaced by increasingly capital-intensive production while not driving down the rate of profit by contributing to surplus goods production (Roelofs, 2003, p. 2). Within this framework it is not surprising to see a parallel increase in philanthropic efforts and increasing socioeconomic inequality, with rising interest in corporate social responsibility and adaptations such as venture philanthropy and Philanthrocapitalism (see Appendix F), operational philosophies in which SIBs clearly advance (Joy & Shields, 2018). This critical perspective also highlights how private non-profit sector production of goods and services share many of workplace perils of private, for-profit production workers who face low unionization rates and minimal job security, are subject to undemocratic workplace governance structures, and whose continued existence relies on the vagaries of funders.

In the end, within this critical political economy framework, the non-profit sector displaces and marginalizes more progressive change and popular movements based on universal access to social programs, with paternalistic charity models focussed on fixing what are deemed individual failings as opposed to looking at the structural nature of capitalist society which generates increasing inequality, alienation, and social exclusion.<sup>31</sup> If NPO stakeholders subscribe to this radical perspective, they will not likely hold an affinity with the corporate and private foundation sector, and view the substitution of public for foundation control over resources in a negative light, likely preferring direct public provision or a *social or solidarity economy* model based on state support for more autonomous collectivist solutions.<sup>32</sup>

This critical political economy framework, arguably however underestimates the salience and persistence of non-self-regarding preferences and their ability to generate effective alternative governance and economic institutions. True to Marx, it assumes that communal and cooperative

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<sup>31</sup> See Gürcan (2015) for an elaboration of this point and the radical critique of the NPO sector more broadly.

<sup>32</sup> See Appendix F for discussion of the social economy and solidarity economy concepts. See also Cooke (2007), working from a critical political economy perspective, who highlights the importance of distinguishing between capitalist versus non-capitalist private ownership structures, such as cooperatives and non-profits, when assessing the impact of privatization.

norms will be swept away by capitalism; but they have persisted, and community governance has proven an effective and efficient counterpart to markets and the state both historically and in modern times (Bowles, 2004, pp. 489-491). While many of the foundations have ties to corporate interests that may sully the perception of their motives, many of the non-profit investors in SIBs appear to be community foundations with diffuse donor bases and genuine community-based relationships and motives, suggesting a range of diversity similar to that characterizing non-profit client service providers. Similarly, a number of the private investors in SIBs are organizations that are seeking to insert social values into investment practices and provide a socially responsible investment as an alternative to conventional savings vehicles. While increased public provision in health, education and other social services is likely defensible on numerous grounds, the ability of the community sector to make up for failings of both the market and government also appears to have its place in efficient public good provision (Ostrom, 2005; Salamon, 1987, pp. 38-42). For non-profits, compliance with government funding requirements can be burdensome (Evans, Richmond & Shields, 2005; McGregor-Lowndes, & Ryan, 2009), and while SIBs may be far from an ideal funding model from an NPO's perspective, it may be viewed as an improvement over the status quo, if appropriately structured in partnership with aligned organizations. While there is certainly some truth in the radical critique outlined above, there also appears to be a role and rationale for localized charitable models in addition to public support.

#### g) Hybridization Objection

A second potential objection to our proposed policy solution set and the non-profit versus for-profit analysis on which it rests, is that it presents a false dichotomy. The delivery of social services and broader addressing of social challenges have undergone massive reforms in both organizational form and practice, and there has been a convergence between non-profit and for-profit provision (Dees & Anderson, 2003). For-profit corporations are increasingly expressing commitment to corporate social responsibility (Graff, Zivin & Small, 2005, p. 1), non-profits are increasingly

embracing the ethos of private sector efficiency (Dees, 1998a), and social enterprises are increasingly being formed to pursue both social mission and profits (see Appendix F). The pursuit of social benefit then is no longer the exclusive realm of NPOs, with the potential to benefit from the best of both worlds and the strong reciprocity that is present regardless of corporate form.

While this challenge legitimately highlights the feasibility of the for-profit structure to be utilized for achieving social purposes, it does not undermine the fundamental disadvantage faced by the for-profit corporation in relation to the non-profit organization in this field. As highlighted by Dees and Anderson (2003, p. 8), social impact is notoriously challenging to quantify and monitor, underpinning the economic rationale of the non-profit corporate form, summarised above in Section II. While for-profit corporations may leverage the goodwill and intrinsic motivations of workers and other stakeholders, the non-profit form is strategically constructed and positioned to better provide reassurance to donors that their contributions, be it money, time or effort, will be dedicated to social mission rather than private gain.

## V. Conclusion

This chapter examines how private organizations and individuals within these organizations participating in SIBs respond to varying institutional contexts and incentive structures that are altered by policy interventions such as SIBs, based on payments based on outcomes. Instead of the atomistic self-regarding, payoff-maximising agent at the centre of the principal-agent model and mainstream economics more broadly, we present research and evidence that frame individuals as socially embedded and other-regarding with reflexive preferences that are context dependant. A focus is placed on the role of assumptions around self-regarding versus non-selfish behavior, the distinction between instrumentalism and principle driven actions, and the importance of understanding behavior as contextual and adaptive to institutional settings. We attempt to

demonstrate how a more complex, coherent and empirically supported construction of motivation that incorporates the role of ethical considerations and intrinsic motivations raises further challenges for an efficiency-enhancing case made on behalf of SIBs.

Specifically, we draw upon the fact that the vast majority of service providers in SIBs are non-profit organizations, are likely to be driven by a social mission, and are more likely to have workers that are driven by intrinsic motivations, in addition to pecuniary concerns for themselves and their organization, to achieve outcomes for their clients and do their work well. This will particularly be the case for smaller community based non-profits. We analyse the implications of the SIB model using the concept of strong reciprocity, the idea that a large proportion of individuals in any given situation are likely predisposed to cooperative behaviour, will undertake self-costly punishment on those who violate norms of cooperative behavior, and value intent and process in addition to outcomes. Based on our model in Chapter 4, this makes it even more challenging for SIBs to out perform conventional delivery.

These findings are used to inform some recommendations for designing SIBs that will minimize the displacement of intrinsic motivation of non-profit stakeholders. These include recommendations to restrict investors to community- respected non-profit investors, offer rates of return below the cost of government borrowing, and earmark profits for reinvestment in social service provision. We also recommend developing outcome targets in conjunction with non-profit service providers to ensure that targets are reflective of overall client wellbeing and success, as opposed to just government cost savings. Within this context, if incremental resources for valued activities are produced through SIBs by circumventing self-imposed budget constraints and tapping into CSR contributions from new partners, SIB models will more plausibly generate improvements over conventional procurement.

If SIBs continue to offer high interest rates to removed for-profit investors without expertise in social service delivery, and set targets in isolation of NPO stakeholder concerns, this has implications for the evolution of the model. If NPOs have staff that are more likely to be dedicated to the well-being of their clients and are less willing to compromise on holistic care which they deem more appropriate but difficult to quantify for outcomes metrics, over time investors and intermediaries may increase their odds of success of hitting specified targets by increasingly relying upon for-profit providers. Alternatively, non-profit providers may shift their behavior in response to a deemed violation of these norms, become disgruntled, and engage in strategic gaming.<sup>33</sup> This is a variation on the idea with the strong reciprocity framework of controlling policy displacing cooperative and altruistic behavior. The work on strong reciprocity suggests that this risks inferior outcomes overall from an efficiency perspective, and the quality of social services procured is likely to suffer. The implications of this are that in addition to reducing the capacity of the state for social service delivery, SIBs may structurally privilege for-profit providers overtime and shift activity away from non-profit service providers, while undermining the effectiveness of non-profit providers who remain. While increased market share and profits did not appear in surveys of stakeholder motivation, we suggest this is potential motivator and should be of concern. Within the non-profit sector itself, the SIB model structurally supports a reallocation of resources away from more activist community-based organizations to larger more conservative non-profits, further displacing more systematic change.

SIBs as currently being pursued, through their PbR structure and emphasis on paternalistic relationships with service providers, impose a self-seeking logic on social service delivery. Given the still current dominant position in social service provision of non-profit agencies with intrinsic motivation and social missions, there is a mismatch between the claims of the model and its likely effects in practice. The centrality of pay by results may be just as likely to backfire as have any

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<sup>33</sup> See Chapter 3 Section II.

meaningful positive effects relative to more conventional contracting forms such as implicit incentive contracts that are based on contingent renewal.

# Chapter 6: GOVERNMENT

## Introduction

As the only commissioning agents and near-exclusive funders of outcome payments to date, government and the broader public sector is arguably the most essential institutional participant in SIBs (Dear et al., 2016, p. 44). Since SIBs are often premised on reducing future social expenditure obligations of government, and it is only the government that can earmark these notional savings for upfront preventative interventions, without the participation of government such self-financing cannot proceed. A few other stakeholders can reasonably be seen to have the obligation to fund the costs associated with allowing social problems to persist, but with the exception of one SIB, all outcome payments have been either funded by government or public sector or quasi-public institutions.<sup>1</sup> We therefore now focus on government, with this chapter examining the motivations and constraints faced by elected officials and civil servants. Here we aim to develop an understanding of what motivates the actions and behavior of government representatives, and how their decisions are influenced by their structural characteristics.

In our analysis in the previous chapter, one challenge we highlighted with the more orthodox principal-agent framework model of SIBs was the assumption of a conflict of interests between government and service provider. This was due to the service provider being modelled as only maximizing pecuniary compensation after accounting for the disutility cost of effort, while ignoring

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<sup>1</sup> A notable exception is private insurance providers, which have genuine contingent financial obligations to support individuals into the future. The only fully private sector funded SIB was issued by the Dutch De Amersfoortse health insurance company (ABN AMRO, 2017). The two SIBs issued in Israel are the only two other SIBs without a lead government outcome funder but had public universities and mandated non-profit health insurers as outcome funders.



alternative drivers such as intrinsic motivations or other-regarding preferences. A shortfall of the model that could be claimed with respect to government is the opposite; that the government representative is modeled as purely benevolent and as maximizing social welfare. As noted by Richard Musgrave (1999), this approach “is helpful to visualize how a correctly functioning public sector would perform [...] to serve as standard” and that “the vision of a first-best solution is needed to identify a feasible second best” (p. 35). However, this public finance or social welfare approach has faced critiques on multiple fronts. Public choice theorists, for example, have argued that rent seeking, where interest groups seek direct or indirect resource transfers at the expense of others, is endemic to the political process and have challenged utilitarian social welfare analysis with notions of justice emphasizing property rights and freedom from interference, while Marxian theories of the state have long questioned the impartiality of the state and its depiction as neutral arbiter in capitalist societies.

Government, like the non-profit sector, is conducive to employment characteristics that attract strong reciprocators, validating an altruistic approach based on the public service motivation framework as reviewed in Chapter 5. However, with respect to the subject matter of SIBs, our analysis so far raises doubts regarding the potential of SIBs to be cost effective relative to conventional procurement. Other critical analyses of SIBs have also brought into question the ability of the SIB model to deliver on the purported benefits identified through reliance on welfare economics and cost-benefit perspectives. Yet SIBs are proceeding and proliferating at a rapid rate. In this chapter we explore potential drivers of state participation in SIBs beyond the assumption that SIBs are being pursued for efficiency reasons, with the state understood as a realm of competing interests.

Here we draw on four stylized theories of the state to frame and construct a model of government representatives of these interests in ongoing competition for control of the state. Here strategic factors will feature prominently in program and policy design once representatives hold decision making power within of state institutions. In the first three, we follow and build on Chang (2002,

2003), using the categories of (neoclassical) welfare economics, neoliberal, and institutionalist political economy. To these three we add a Marxian theory of the state. Neoliberal, Marxian and strands of institutionalist thinking all support a model of state decision-making based on political competition for control of the state that we believe can provide some insight to the emergence of SIBs. The proposition that SIBs could be used by state leaders to better their standing vis-a-vis political competitors will be explored. Specifically, the idea is explored that state leaders implement SIBs as they allow them to reinforce their class-based political alliances and service more potential support from voters in the medium term, while obfuscating the cost impact of these activities, through off-budget accounting.

This chapter proceeds as follows. Section I presents a brief summary of survey-based evidence and other scholarship examining government motivations for participating in SIBs. Section II recaps what we call a *relative cost critique* of SIBs, motivating the development of an alternative, non-efficiency-based rationale of state engagement in SIBs. Section III summarizes four competing theories of the state in economics and discusses their implication for SIBs. Section IV puts forward policy recommendations to help mitigate the potential that SIBs would be used when contrary to the public interest such that alternative delivery could achieve targeted outcomes more efficiently. Section V concludes.

## I. Motivations of Government

It has been suggested that government representatives issuing an SIB will be concerned with a variety of factors including how SIBs align both with overall government priorities and those of the specific department or agency assigned to implement and administer the SIB on behalf of government (Maier & Meyer, 2017, p. 3). Publicly stated rationales of governments embarking on SIB projects generally echo the rhetoric of early proponents of the SIB model, highlighting the win-win scenario of cost savings financing the intervention or not having to expend public funds on the

project.<sup>2</sup> In survey and interview data, government outcome funders echo reasons expressed by investors and service providers related to innovation, collaboration, and a focus on outcomes (Gustafsson-Wright et al., 2015, p. 25). Government may also be motivated to engage with SIBs due to the expected benefits of financial sector investment and insight (Liebman & Sellman, 2013, p. 9).

While the above reflects the efficiency enhancing potential of SIBs, more political-economic factors have also been noted as motivators (Maier & Meyer, 2017, p. 3). In surveys, government stakeholders also emphasized overcoming internal government constraints, restricted budgetary resources as well as “budget silos, procurement issues, hurdles in the budgeting process, and political barriers” as motivation for the SIB model (Gustafsson-Wright et al., 2015, p. 25). Government may engage with SIBs due to the ability to transfer risk (Liebman & Sellman, 2013, p. 9), which allows governments to pass off responsibilities for high profile program failures and the negative publicity to private sector agents.<sup>3</sup> SIBs may also produce reputational benefits for governments given their growing status as an innovative delivery method and may also be adopted based on a desire to “imitat[e]... the actions of other governments that they regard highly” (Maier & Meyer, 2017, pp. 6-7). Governments may be interested in payment by results schemes more generally as success can convey competent governance and, at the local level, can leverage national/federal government outcome payments, bringing additional resources to the region (Courty & Marschke, 2011b, pp. 71-72). SIBs may also allow government to initiate incremental social service programing while temporarily keeping the cost off of government balance sheets, allowing governments to report lower projected deficits.<sup>4</sup>

There are also indications that government stakeholders are not united in their embrace of the SIB model, as the interests of elected officials, workers in the civil service, senior management, and

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<sup>2</sup> See Appendix A, Office for Social Innovation and Civic Participation (2016), Cabinet Office (2013), State of New South Wales (Office of Social Impact Investment, 2017), Government of Canada (2015), Government of Ontario (2017); Government of Saskatchewan (2015).

<sup>3</sup> However, as discussed in Chapter 3, full risk transfer is challenging given the perceived end responsibility held by governments to address social challenges (Fraser, Tan, Lagarde & Mays, 2018, p. 15).

<sup>4</sup> See Chapter 3 Section I for further discussion of this point.

other public sector stakeholders may not be in alignment. Some public sector stakeholders, for example unions representing civil servants, have publicly opposed and been critical of SIBs in both Canada (Malcolmson, 2014; NUPGE, 2012) and in the United States (Gregg & Bogdan, 2014), based on their privatization elements and questionable effectiveness. The House of Lords (2017, p. 86) in the UK has also called into question the emphasis placed by the UK government on the model. There has been “vociferous opposition” (Dear et al., 2016, p. 44) to SIBs in certain countries, leading to governments being more hesitant and restrained in adopting the model. This suggests that decision making around SIBs and the policy making process more generally is a contested terrain with competing interests.

## II. Relative Cost Critique

A series of authors have argued that SIBs face some fundamental challenges on their own terms, questioning the ability of SIBs to deliver on the effectiveness and innovation proclaimed by proponents and undermining efficiency-based explanations of SIB emergence (Fox & Albertson, 2011; Joy & Shields, 2013; Lake, 2015; Loxley, 2013; Loxley & Puzyreva, 2015; McKay, 2013; Roy et al., 2017; McHugh, et al., 2013; Stid, 2013; Warner, 2013; Whitfield, 2015). This literature situates SIBs within the broader neoliberal or New Public Management reforms of public administration, including contracting out, a focus on ‘value-for-money’, and greater reliance on the private sector through vehicles such as public private partnerships. These authors highlight that SIBs neglect the existing strengths and advantages of conventional non-profit and government provision, and in practice face challenges with respect to delivering cost effective public services, with at least three challenges.

First, SIBs face the added costs of having to cover the additional administrative and transaction costs associated with the rigid and high-stakes contracting structure inherent in the model. SIB contracts need to clearly specify in advance the targeted outcomes and metrics of evaluation, as well

as all contingencies that may arise and the associated repayment terms for investors. Each party to the transaction will need to obtain specialized legal expertise to make sure their interests are properly reflected in the associated contracts between stakeholder groups. Doubts have been raised that the current scale of SIBs can overcome these transaction costs given their current scale (see also: KPMG, 2014).

Secondly, SIBs must cover the returns of successful investors over and above the government cost of borrowing, a cost not present in more conventional delivery models. From the investors' perspective this profit margin is justified given the risk that investors face and the value added that they bring to the projects, but the veracity of these claims are tenuous. Expected and maximum rates of return on SIBs for investors on average are significantly above government cost of borrowing and based on the limited data that has been publicly released, SIBs appear for the most part to be meeting their outcome targets, suggesting that minimal risk transfer may be occurring in practice.<sup>5</sup> Governments then for the most part are presumably repaying investors as per the specified terms, meaning that additional public funds are required to cover incremental costs associated with the spread between government borrowing rates and investor returns. It is also unclear what expertise investors are bringing to the project other than financing and monitoring, given that for the most part, agencies being hired appear to have track records of successful social service delivery.

Thirdly, SIBs have the potential to introduce inappropriate and detrimental incentive structures that may have unintended consequences on the behavior of service organizations. The pay-by-results structure associated with SIBs has led to both concerns and accusations that strategic gaming has taken place in some SIBs, where, for example, client groups were selected because they were easy to serve, and targets would be easily met.<sup>6</sup> More generally, there is empirical evidence to support that workers in public and nonprofit sectors self-select occupations based on pro-social or an altruistic-

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<sup>5</sup> See Chapter 2.

<sup>6</sup> See also Edmiston and Nicholls (2018) and Popper (2015).

type commitment to public service, and that performance-based incentive may displace these motivations. This, and other characteristics of the public service (see: Dixit, 2001) make it unlikely that crude performance-based incentives will have the desired effect, and in fact may be detrimental. In the SIB case, for example, workers may see their programs and efforts diverted to meet narrowly defined indicators of success as opposed to the broader needs of their clients, and money leaving the social service sector towards for-profit investors (Edmiston & Nicholls, 2018).

The above review raises significant doubts regarding the potential of SIBs to be cost effective relative to conventional procurement, motivating a search for alternative explanations of SIB emergence. To understand why governments implement SIBs requires a theory of the state that frames how decisions are made and what motivates government stakeholders to select particular policy approaches over others.

### III. Theories of the State

This section summarizes four traditions of economic thought that will be used to frame our analysis of the motivations and behavior of government in relation to SIBs. These include two orthodox traditions, the neoclassical and neoliberal schools, and two heterodox traditions, institutionalist and Marxian economics. Within our 'neoclassical' category we will include welfare economics and public finance approaches, while our heterodox institutionalist approaches will incorporate insights from the 'old' institutionalist tradition and subsequent evolutionary and behaviorist approaches.

#### a) Neoclassical

Theories of the state can be classified into two broad categories, "contract theory" and a "predatory or exploitation theory" (North, 1979, p. 250; 1981, p.21) that in a manner parallels the traditional equity versus efficiency distinction in mainstream economics. The first emphasizes the

potential collective gains that government facilitates, and the subsequent incentives that individuals have to voluntarily collaborate. Unlike the other approaches to the state which draw on elements of both, the neoclassical welfare economics school relies on a contract theory of the state, which is inextricably tied to the two subsequent rationales: the first is the *public goods* rationale where certain goods can be consumed collectively by many without additional cost or detriment to others once supplied, such as national defense; the second is the more straightforward benefits of coordination, such as determining on what side of the road to drive (Hardin, 1997). The two are distinguished by the potential incentive to free ride on public goods through the avoidance of payment, where in the latter once the norm has been established there are minimal enforcement costs given the inherent benefit to all of abiding by the norm. In addition, the interaction of private actors in free markets may give rise to positive or negative externalities that are not incorporated into the incentive structure of private agents.

Public goods, gains from coordination, and the presence of externalities create space in a market system based on private ownership for government intervention to rectify the resulting market failures that result in pareto-inefficient outcomes. This is a version of the state, combined with distributional considerations, that gives rise to the notion that society collectively can be represented by a social welfare function, and can be thought of as the public finance or welfare economics approach.<sup>7</sup> Within this broader framework the state is presented “as an association of individuals engaged in a cooperative venture, formed to resolve problems of social coexistence and to do so in a democratic and fair fashion... based on and reflecting the shared concerns of its individual members” (Musgrave, 1999, pp. 31). This *public finance* approach assumes as a starting point that the government sets out to act in the best interest of its citizens as reflected by their individual preferences.

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<sup>7</sup> This approach originates back to Bergson (1938) and Samuelson (1954).

A public finance or welfare economics theory of the state was the dominant theory of the state in the post war era. Based on neoclassical theory, this theory of the state emphasized how the real-world economy deviated significantly from the optimal scenario of Walrasian general equilibrium thereby necessitating an active role for the state in managing and participating in economic affairs (Chang, 2003). The neoclassical welfare economics theory of the state forms the basis of government action in the principal-agent approach utilized in Chapter 3, in that the principal is a government representative selecting a delivery structure based on maximizing the net benefit to society of a given intervention.

## b) Neoliberal

Neoliberal state theory is a semi-coherent combination of neoclassical economics augmented with Austrian–Libertarian political philosophy and economic ideas regarding individual freedom, the role of markets, and government officials, based on the following three central components (Chang, 2003, pp. 47-48). First, the neoliberal theory of state adopts a *contractarian* perspective on the nature of the state, such that any role for the state beyond a basic enforcement of property rights specifically and the broader rule of law more generally is questionable from a moral or ethical perspective. Individual freedom to pursue their self-interest through market exchange and free from state intervention takes primacy over efficiency considerations.

Secondly, the neoliberal perspective views the market as an effective information processor that cannot be outdone by central planning (See also: Mirowski, 2015, p. 435). While markets may not be perfect in the neoclassical sense, they are the most effective mechanism to coordinate the preferences and activities of autonomous individuals given the high potential of the government to also fail.<sup>8</sup> The state's ability to improve outcomes through intervention in the market economy is claimed to be highly limited due to information constraints and within neoliberal state theory it is implausible for the state to effectively identify market failure as well as constructively intervening to address it.

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<sup>8</sup> See Becker (1958) for an early expression of this concern.



Intertwined with this government failure approach, neoliberal state theory has worked to restrict the domain of genuine market failure to a few basic areas related to the enforcement of property rights and the rule of law and large-scale infrastructure projects.

Thirdly, the neoliberal state models governments as composed of rent-seeking and easily corruptible politicians and bureaucrats, and therefore emphasizes a predatory theory of the state. This is based on the work of the public choice school, whose study of government and politics is based on the “basic behavioral postulate... that man is an egoistic, rational, utility maximizer” (Mueller, 2003, pp. 1-2). In this sense the public choice approach is a natural exertion of more narrow version of neoclassical theory of the individual to state actors, where a single ruler has a natural monopoly on force at a particular geographic scale, and therefore the enforcement of property rights, and seeks to maximize rent extraction (North, 1981). With respect to the civil service, public choice assumes that imperfectly supervised government workers seek to maximize their power reflected by the size of their budgets and therefore will oversupply publicly provided goods (Bel, Fageda, & Warner, 2010, p. 555; Letza, Smallman, & Sun, 2004, p. 165), and models politicians as vote maximizers who compete for votes and set their policies solely based on achieving this goal, in turn to get access to the benefits associated with holding office (Downs, 1957). This latter approach generates the median voter theorem, the idea that politicians will converge to the preferences of the median voter if preferences and candidates are limited to a single dimensional metric, for example rankings on a left-right political spectrum.<sup>9</sup>

This leads to a system of government highly responsive to the desires of voters when voters are well informed, however the application of public choice’s optimizing rational egoist model of human

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<sup>9</sup> Hotelling (1929, pp. 54-55) described the convergence of political platforms in a two-party system to maximize votes, a notion that was subsequently examined more systematically in Downs (1957) and Black (1958). Roemer (2006) examines the limitations of this approach and the challenges and implications of extending the model from a single dimension to multi-dimensional policy spaces, and from a deterministic framework to a probabilistic framework that introduces uncertainty with respect to voter and politician knowledge regarding each other’s characteristics. He also examines the implications of modelling politicians as having preferences over possible government practice and policy outcomes instead of, or in addition to, the desire to hold decision making power and the associated benefits. He however highlights that “probably 95 of the formal literature in political economy since Downs” has stayed within the deterministic, vote maximizing, single issue dimension framework (Roemer, 2006, p. 3).

behavior undermines this result. In this framework, voters vote based on self-interest. Given that the cost of voting is real in terms of opportunity cost of time and effort, and a single vote is highly unlikely to make any difference in the outcome of an election, rational egoists have little reason to vote or pay much attention to politics in general. This leads to the behavior of politicians being open to the influence of interest groups who organize to directly or, more commonly, indirectly redistribute income and or/wealth to themselves through government policy change.<sup>10</sup> Interest groups in this framework support policy change in their favor by delivering votes and resources to politicians who in turn implement favored policies to secure reelection.<sup>11</sup> Rational politicians in this framework then balance the benefit of catering to interest groups in return for campaign contributions and voter mobilization with the probability of alienating the much larger but less attentive voters who are not members of the interest groups in question (Austen-Smith, 1987; Denzau & Munger; 1986).

The conclusion arising from the public choice approach is that regulation, redistribution, and other interventionist government activity is even more detrimental to economic efficiency than typically argued by neoclassical economists.<sup>12</sup> This is due to private sector actors now acting through interest groups, shifting resources away from production activity to unproductive redistributive efforts, seeking to generate transfers or economic rents from favorable policy (Buchanan & Tullock, 1962; Tullock, 1967). This is made possible again by rational inattentiveness of self-regarding voters who assume such a small share of the burden, spread out amongst tax payers as a whole, that it is often not worth their time or effort to engage in counter-mobilization. Neoliberal state theory based on early public choice theory then cautions of the tendency of state to grow to the detriment of the

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<sup>10</sup> For seminal development of the public choice interest group approach, see Olsen (1965), Stigler (1971), and Peltzman (1976). For another approach that fully and explicitly integrate voting processes with interest group behaviour see Lindbeck & Weibull (1987).

<sup>11</sup> Stigler (1971, p. 13) highlights, for example, how certain occupations for politicians, for example in law and finance, are particularly well placed for accepting indirect benefit through the firms of politicians, private service sectors which SIBs also employ extensively.

<sup>12</sup> These results hinge heavily on these questionable assumptions, and leads to some fundamentally misleading conclusions that are not consistent with the empirical evidence, with both the assumptions and the predictions of the theory facing challenges (Chernomas & Hudson, 2017, pp. 92-105; Pressman, 2004; Quiggin, 1987). In addition, alternative analyses that consistently apply mainstream economic theory to political markets that include political parties, interest groups and political institutions as mechanisms for disciplining predatory behavior, find that democratic political competition can produce efficient outcomes in a similar manner to how market competition disciplines firms (Wittman, 1989).

public interest, and prescribes vigilance in this regard, particularly with respect to the damage caused by interest groups.<sup>13</sup>

Within this framework state leaders that set policy and oversee the allocation of government resources will be pressured to deliver on commitments made to interest groups and will adapt fiscal policy and structures of government where possible to accommodate. This political competition influences the development of government institutional structure, with elected officials structuring bureaucratic institutions to their advantage (Moe, 1990). Incumbents in the lead up to elections will use fiscal policy to signal political competence in ability to deliver benefits to voters post-election (Rogoff, 1990; Rogoff & Sibert, 1988). These for the most part take the form of micro-level policies that are utilized such that benefits are concentrated to favor their targeted voters, sympathetic interest groups, and particular constituencies (Drazen & Eslava, 2010; Wagner, 1977).<sup>14</sup>

More recent studies loosely in the public choice tradition have utilized the descriptor *Machiavellian* to describe a related politically-motivated form of strategic privatization and contracting out, used by right-leaning political parties, as a means to cultivate the political support of centrist voting blocs and build broader support for privatization.<sup>15</sup> This type of procurement is not

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<sup>13</sup> This strictly critical assessment of interest groups is not equally held by the Chicago school of rational choice political economy, sometimes included in a broad definition of public choice (See Chernomas and Hudson, 2017, pp. 92-105; for example) who also apply the rational egoist model of behavior to the political system and interest groups. Peltzman (1976), building on Stigler (1971), highlights how the rational inattentiveness of voters will set limits on the ability of interest groups to capture public officials. Interest groups will stay small and concentrated, as large interest groups will raise the ire of taxpayers as well as free rider problems. Becker (1983, 1985) more clearly emphasizes how interest group competition can be beneficial when groups have equal access to political power, and that “the condemnation of special interest groups is excessive because competition among these groups contributes to the survival of policies that raise output” (p. 344), a conclusion explicitly in contrast to the more classical Virginia School of public choice. Wittman (1989) and Coughlin, Mueller, & Murrell (1990) both take this approach even further arguing that democratic political competition and effectively functioning interest groups can produce efficient outcomes in a similar manner to how market competition disciplines firms and produces pareto efficient outcomes.

<sup>14</sup> Several studies note that deficit spending does not lead to electoral success and/or that reducing deficits is associated with greater electoral success in some circumstances. See Alesina, Travotti and Tavares (1998), Brender (2003), Brender and Drazen (2008), Drazen and Eslava (2010), and Peltzman (1992). Alesina et al. (1998) argue explicitly that the lack of negative voter response to reduced spending and deficits is linked to preferences of voters for conservative fiscal policy. These constraints may result in politicians alternatively increasing spending on target constituencies in the lead up to elections by reallocating spending as opposed to increasing overall expenditure (Drazen & Eslava, 2010). There is also evidence that governments manipulate financial reporting, through either flexibility afforded by accounting conventions or by not acknowledging liabilities, particularly in election years, to present a more favorable fiscal picture of lower deficits or higher surpluses to the electorate - see Kido, Petacchi and Weber (2012) who find that these effects are lesser in states where state auditors have greater independence. See also Sbragia (1996), who presents a compelling narrative of the political economy of US municipal finance focused on how municipalities have come up with innovative financing structures to circumvent state limits on spending through the establishment of authorities, embedded in an interest group framework.

<sup>15</sup> See Bel and Fageda (2009), Biais and Perotti (2002) and Sundell and Lapunte (2012). There are at least two bodies of literature looking at the explanatory factors of privatization, one that is European based and focused on the privatization of State Owned Enterprises, and a US-based literature looking at the contracting out of local government services (Bel & Fageda, 2007). SIBs are a form of contracting out

only about a government catering to its base of support, but also using procurement to shift the preferences and/or interests of undecided or unaligned groups towards those of the government in power and its core supporters. For example, right leaning governments may privatize a state enterprise through the sale of undervalued shares, aiming to curry favor of target populations in favor of privatization and/or manipulate the political identity of new shareholders towards business interests (Biais & Perotti, 2002; Sundell & Lapunte, 2012, p. 72).

The empirical literature on Machiavellian privatization, generally focused on local municipal service contracting, has proposed a number of explanatory variables to explain the degree of contracting out amongst different governments.<sup>16</sup> These can be grouped into the following categories, with an increase in the variable being associated with a higher degree of privatization: (1) fiscal constraints (2) economic efficiency or cost reduction potential through economies of scale or increased competition; (3) relative power of interest groups, primarily categorized as those associated with capital and those with labor; (4) ideological commitment of the governing party to the 'free market'; (5) positive opinion of the electorate regarding privatization; (6) ease of political decision making in the given political governance structure.<sup>17</sup> Political competition will also play a mediating factor dependent on the ideology of the government party.<sup>18</sup> Table 11 provides examples of indicators used to measure or proxy for these explanatory variables:

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and therefore the methods in the latter body of literature are more applicable for this dissertation. Also, Antellini-Russo and Zampino (2012) utilize the Machiavellian procurement descriptor to explain the utilization of PPPs.

<sup>16</sup> See Bel & Fageda (2007) and Bel & Fageda (2009) for summary reviews of this literature, and Sundell & Lapunte (2012) for a more recent analysis.

<sup>17</sup> Note that this approach moves away from the more classical public choice approaches based on vote maximizing and incorporates political parties and ideological considerations, that may incorporate other-regarding preferences. Kalt & Zupan (1984) however note this still fits within the broader rational choice as a consumption good based on ideological preferences. Alternatively, they note ideology can be reduced to a strategic rule of thumb aligning with constituent interests, in a context of rational inattention and other information asymmetries, as originally noted by Downs (1957, pp. 96-114). With respect to voters, they note that ideologically driven preferences "poses no problems for the economic theory of politics. Publicly interested ideologues are just another special interest capable of capturing the political process, subject to the comparative statics of organizational costs and benefits" (p. 281).

<sup>18</sup> A significant positive interaction between (4) and (7) supports the presence of Machiavellian contracting, since as political competitiveness intensifies and control of the state is threatened, right-wing governments will be motivated to increase their use of strategic privatization to get political support (Sundell & Lapunte, 2012), while left-wing politicians will be more likely to contract out when they have a comfortable majority since their interest group base is opposed to privatization. It has been noted that left-wing governments usually privatize to generate funds, seeking the highest financial gain, as opposed to for vote gaining purposes (Biais & Perotti, 2002), again producing a positive interaction effect.

<u>Explanatory Variables</u>	<u>Rationale</u>	<u>Indicator or proxy</u>
(1) Fiscal constraints	Deficits are politically unpalatable <i>ceteris paribus</i> . Privatization allows for shifting of expenses off-books and/or produces windfall gains from concession contracts or asset sales.	Borrowing rates or debt rating of government debt; equity ratio of government*; tax levels †; legislated budget constraints†; funds from higher levels of governments†
(2) Economic Efficiency	Potential cost savings permits deficit reduction or new spending on additional political priorities.	Population size being governed*†; number of registered stock companies*; geographic size of political unit*; measures of transaction costs†;
(3) Relative power of interest groups	Labor will oppose contracting out while capital will support.	Unionization rate†; percentage of workforce in public sector†; source of financial campaign contributions to politicians;
(4) Ideology of governing party	Right-wing political parties or individual politicians will support contracting out, left-wing politicians will oppose.	Number of seats of each party in legislature, ranked ideologically on left (-) – right (+) spectrum; indexes of survey-based ideological rankings of individual politicians*;
(5) Opinion of the electorate regarding privatization	Politicians, due to electoral competition, will be influenced by the will of the electorate.	Median annual income*; percentage of various income groups of total population†; votes cast for different politicians by ideology†
(6) Political governance structure	Contracting out will be more likely where decision power is consolidated and change is easier to implement.	Number of veto players in government decision making structure*
(7) Degree of political competition	A higher intensity of political competition will drive politicians who benefit from politically-motivated contracting out to do so at a higher rate.	Margin of victory of electoral mandate*; size of majority in legislature*

† Noted as common regressors in Bel & Fageda's (2007) review.  
\* Utilized by Sundell & Lapunte (2012)

All of the above factors fit into a more generic political competition, where all politicians face political competition and utilize control over government resources to reinforce public support, subject to fiscal constraints and institutional structure. Ideological commitment identifies a center or base of interest group support for a particular government, while the strength of these groups and to a lesser extent public opinion, influence the balance of power within and between governing political parties and/or coalitions. Fiscal constraints and economic efficiency affect the ability of governments to respond to interest groups. Looking specifically at the SIB model, one would also likely seek a

dependent variable associated with the degree of financialization or the relative power or influence of the financial sector.

## Implications

Within the broader neoliberal theory of the state and the specific notion of Machiavellian privatization, SIBs can then be understood as a specific type of contracting out or privatization that may allow vote maximizing politicians to better garner the support of interest groups and inattentive voters, at least in the short term, by redirecting spending towards popular programs and improving the publicly reported budgetary indicators broadly interpreted as measures of government performance.<sup>19</sup> At the elected official level, the SIB model presents several advantages for public sector decision-makers facing significant budgetary constraints who prioritize lower reported deficits and high-profile targeted spending over value for money considerations. This is consistent with a survey of government participants in SIBs who indicated scaling up the proposed social service activities in the face of budgetary limitations was a recurring motivation (Gustafsson-Wright, et al., 2015, p. 25; Warner, 2013, pp. 11-12). As discussed in Chapter 3, the current accounting treatment of SIBs allows for the potential for SIBs to go unaccounted for in public accounts until the outcome payment are to be made, pushing costs off, potentially to future governments. Within this context, and assuming the political competition approach, governments, investors, and service providers jointly have the incentive to construct SIB projects with outcome targets that are easily achieved and with excessive rates of return (Maier & Meyer, 2017, pp. 6-7), such that rates are higher than required to attract investors.

Aspects of the neoliberal theory of the state provide a degree of normative and positive support for the SIB model, but also raise concerns. In general, public choice theory provides an underlying rationale for the proponent case for SIBs based on the disparagement of government capabilities.

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<sup>19</sup> There is empirical evidence to support that voters are generally in favor of greater investment in preventative social services. See for example Lipsey & Cullen (2007, p. 316) and Public Health Association of Victoria and VicHealth (2011).

SIBs may lead to greater efficiencies relative to bureaucratic administration in the neoliberal framework because governments are prone to failure due to power maximizing bureaucrats, and markets are the best mechanism to process information and allocate resources in neoliberal theory. The contracting out of project management activities in addition to service provision, and the creation of quasi-markets through the issuing of investment shares and payment based on results, all lead to better alignment of incentives and may reduce the discretionary power of self-interested bureaucrats.

While neoliberal theory provides incremental rationale for SIBs, SIBs are only a partial solution given the remaining centrality of the state in setting outcome metrics and the fact that SIBs use taxation revenue to fund in-kind social services, undermining consumer sovereignty on both fronts. In this context, the public choice perspective raises concerns with investors and intermediaries utilizing the process to extract rents, and politicians and bureaucrats using SIBs to mask increased spending and inflate their sphere of influence - by temporarily skirting legislated budget constraints or exploiting information asymmetries given the complexity of the model, for example and in turn increasing the tax burden on the population more broadly, targeting benefits strategically to support reelection.

### c) Heterodox Institutional

Chang (2002, 2003) acknowledges that the Austrian information critique and the ignorance of the role of interest groups are genuine weaknesses in neoclassical welfare economics but suggests this does not necessarily support a case against an active and interventionist state with respect to the economy. He notes cases where the state has been effective in constructing institutions that help mitigate risk arising from information deficiencies and points to work with coalitions of interest groups to achieve developmental goals. He proposes an *Institutionalist Political Economy* (IPE) theory of the state in “the tradition of... Karl Marx, Thorstein Veblen, Joseph Schumpeter, Karl Polyani, Andrew Shonfield, and Herbert Simon” (2002, p. 551) as well as Kenneth Arrow (2003, p. 51). Chang’s



IPE approach is generally consistent overall with the heterodox institutionalist tradition, also tracing its roots to Veblen as well as John Commons and Wesley Mitchell, with more modern scholars in the tradition such as Geoffrey Hodgson.

The heterodox institutionalist approach is similar to a welfare economics approach in that the theory lays out the theoretical basis for a strong role for the state in the economy. However, it departs from the market-centric neoclassical framework of optimization, perfect information and fixed property rights and technologies, with the state playing a leading entrepreneurial role as a vision setting-coordinator, a builder of institutions, and as a conflict manager (Chang, 2003, pp. 51-63). Within this framework the market solutions may or may not be more effective; the market does not have an a priori privileged position in the institutionalist framework as in the neoclassical and welfare economics approach, with markets themselves being socially constructed institutions that often had to be violently imposed with the backing of the state to displace traditional non-market institutions of provision and exchange. Political means have been and continue to be utilized in the assignment of property rights and other “rights-obligation structures” (Chang, 2002, p. 550) that continually evolve and shape the determination of the institutional structure that is taken as given in neoclassical theory. Minimizing the state to avoid politicized use of the state is critiqued as a flawed normative prescription as it does not speak to this continuous struggle, the political nature of the market, and the relative demerits of non-intervention and examples of successful state-led economic transformation. Within the heterodox institutionalist approach there is no a priori natural boundary between the state and the market, and politics is the mechanism to engage and manage this contested delineation.

Since institutionalist economists focus on the social provisioning process more generally, with markets not having privileged status as in neoclassical economics, the state, with other institutions such as the family, are viewed as other important institutions of production and allocation. The state however is privileged in its ability to play a central role in purposefully influencing the development



and evolution of other provisioning institutions (Whalen, 1993). The state in institutional economics is a “pragmatic state” that arises from the necessity for the “institutional coordination of collective problem solving” (Waller, 2008, p. 31). In this sense it advances a contract theory approach to the state. However, linking back to the work of Veblen, the importance of power in economic relations and the economy is also a central concept in institutional economics, and the state as a central mechanism in allocating power is then an important institution of study, leading to a recognition of how dominant interests within the state reflect class power (Wunder & Kemp, 2008, p. 40). Veblen’s discussion of government preempted public choice in the broad sense of government and politics being a tool of special interests, but for Veblen the special interests that were served were those of the business class; and rather than rational inattention Veblen pointed to an irrational patriotic affinity of the common people towards the propertied classes of one’s nation (Leathers, 1989, pp. 295-296). Veblen also preempted the basic premise of Downsian-style political competition and the coming together of parties’ policy proposals, but again these were tethered to the interests of the business class, although these ideas did not have longevity in Veblen’s writings over time (Leathers, 1989, pp. 296-297).<sup>20</sup>

This critical view of the state as beholden to business interests is not consistent within the broader heterodox institutionalist tradition. More commonly institutionalists speak to the need and ability of the state to manage competing interests and formulate a shared vision for economic development and management. If one goes back to John Commons, it is through the conflict between interest groups that stability and popular consensus is generated, suggesting that equitable access to power through free association will facilitate this process (Wunder & Kemp, 2008, p. 400).<sup>21</sup> More generally, the institutionalist approach views the state as a constructive and progressive means for resolving conflict if based on democratic participation.

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<sup>20</sup> Leathers (1989) highlights how Veblen, while for the most part committed to the notion that government policy is driven by business interests, at times was not consistent on this point and had suggested also the potential of self-seeking government officials and business profiting off government to lead to runaway growth of the state to the detriment of broader economic wellbeing.

<sup>21</sup> This prescription is similar to some mainstream theorists utilizing neoclassical behavioural assumptions. See footnote 11 above.

The institutionalist approach rejects the notion of the self-regarding rational egoist as an accurate reflection of human behavior more generally, and specifically in the context of politicians and government, highlighting the clear empirical evidence of non-self-regarding behavior, particularly in public life, based on “moral views and social norms” (Chang, 2002, p. 549) and the endogenous adaptation to public service values through participation in collectivist institutions.<sup>22</sup> This is consistent with the broader commitment within the institutionalist approach to preferences as being endogenous and socially constructed. The institutionalist approach highlights how many neoliberal prescriptions for regulating and motivating civil servants may be counter-productive and may crowd out intrinsic motivation (Chang, 2002, p. 549).

The heterodox institutionalist tradition primarily defines itself in relation to and distinct from neoclassical economics.<sup>23</sup> While there is strong emphasis on modeling the economy as an evolutionary system, how the economy or institutions evolve over time in the broader heterodox institutionalist approach is highly context specific and/or path dependent, with institutionalists relying on the notion of “cumulative causation” (Hodgson, 1993, pp. 17-19). This notion aims to include “all relevant factors” which “can...only be determined empirically” and “den[ies] the existence of a primary cause” (Berger, 2008, p. 359), leading to accusations that that institutionalism is atheoretical and only concerned with specific policy problems. Defenders of the approach dispute this claim (Hodgson, 2000). Within the institutionalist evolutionary approach, temporal and geographic differences arising historically will result in a diversity of institutional governance structures.<sup>24</sup> Given this commitment to context and institutional specificity, institutionalist theory does not produce predictive tendencies of the state in “general or abstract”, as such would be a “methodological contradiction” (Waller, 2006, p. 14). This open-endedness, combined with its

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<sup>22</sup> Our discussion in Chapter 5 of public service motivation and strong reciprocity at a high level serves as possible foundations for these notions.

<sup>23</sup> See Hodgson (1993) for example.

<sup>24</sup> See Ebner (2006) who summarizes Schumpeter’s theory of the state, which is firmly in this institutionalist tradition, where institutional diversity is emphasized, with states varying from entrepreneurial and growth promoting to parasitic and retarding, emerging from both social contract and exploitative state types.

pragmatic approach to socio-economic provisioning and existentialist underpinnings emphasizing human agency, center the institutionalist's instrumentalist approach on the feasibility and desirability of conscientious and purposeful policy reforms and economic leadership (Dugger, 1988).

## Implications

The institutionalist approach has ambiguous implications for understanding and evaluating the SIB model. More generally, heterodox institutionalism, and in particular Chang's IPE, is a theory of how state apparatus can function well and the potential of constructive state economic leadership, if led by well-meaning social planners unwilling to shy away from constructive interventionism. In this sense it suggests skepticism of the privileged status SIBs provide to markets and privatization. Based on strong empirical foundations, the institutionalist critique of human motivation and behavior represented by optimization and self-interest fundamentally undermines the outcome implications of the public choice modelling of interest group behavior, creating the potential for interest group advocacy and civil participation mediated by the state as a means for social progress. Together this undermines public choice's disparaging view of government capabilities.

The institutionalist epistemological framework however is based on a context of "dynamic and evolving social reality" (Whalen, 1993, p. 63) with fundamental uncertainty and limitations of our comprehension of the outcomes of social processes and interventions. Given an emphasis on the constructive role of the state in facilitating collaboration between different stakeholder groups with dispersed information to resolve social challenges, institutionalists, like neoliberals, then may provide some nominal support for SIBs. In this context, SIBs can be seen as a specific product realized from an environment of "democratic experimentalism", which beneficially reconciles activist governance features within delegated governance frameworks (Dorf & Sabel, 1998, p. 267). SIBs fit similarly well into Roberto Unger's (2009) call for a "reconstructive Left", which would strive for "socially inclusive growth" based on "experimental co-existence of different regimes of private and social property, as well as of different ways of relating governments to firms" (p. ix). In Unger's

framework, “generalization of the work of venture capital beyond the confines of the private venture-capital industry” (p. 91) would take place, with the goal to “democratize the market by extending the range of its legal and institutional forms” (p. 92). Specifically with respect to government provision of social services, Unger argues that “the state should provide directly only those services that are too difficult, too expensive or simply too new to be provided by private providers” and that government role should be to “act as a vanguard, developing experimentally new services or new ways of providing old services” through “experimental diversification on the basis of a loose set of associations between governmental and non-governmental initiatives” (p. 86-87). At its foundation, these approaches recognize that “the cost of producing a good or service is not defined by a publicly-accessible production function but depends on the capabilities of the particular people who produce it” with these capabilities requiring coordination in a manner that does “not inhibit their continuing development” (Loasby, 1999, p. 157). SIBs in this context may serve a discovery-type purpose in a dynamic setting with incomplete information regarding the social service delivery set and the optimal delivery structure that facilitates the agglomeration and application of dispersed knowledge and skills. Given this context of uncertainty, government representatives may in fact engage in SIBs from a place genuinely reflective of the pursuit of public interest.

#### d) Marxian

Although Chang’s IPE approach references Marx as one of several sources of methodological inspiration, the heterodox institutionalist approach is generally seen as separate school from Marxian state theory that, while sharing some features with the institutionalist approach, is distinct in its analysis and implications. Based on the peripheral discussion of the state in Marx’s original works, early Marxian state theory generated an eclectic collection of ideas, which in different contexts framed the state as: a parasitic and peripheral entity, a simple manifestation of class relations, a mediator of inter- and intra-class conflict, a tool of direct class domination, an apolitical set of institutions, and a more complex infrastructure not directly dominated by the ruling class but with

tendencies to systematically advance and protect its interests in an indeterminate manner (Jessop, 1990, pp. 26-29).

Modern Marxian theories of the state build on this last conception and view the state as a social relation structured as an adaptive set of institutions that enable and facilitate commodity production and exchange which cannot be provided by individual capitalists or blocs of capital through decentralized competition. The state creates and manages institutions, with capital, and if successful, achieves the required conditions for accumulation through class struggle, in a non-deterministic or non-mechanical fashion, subject to tendencies arising from capitalist competition.<sup>25</sup> The state also coordinates relations between tranches of capital, organizing them into a semi-coherent alliance for this purpose. The form of state that emerges in a given context is historically-specific and subject to pressure from class struggle and other broad-based popular movements, but with a pervasive tendency for the broader public interest to be framed in alignment with the interests of capital.<sup>26</sup>

Marxist analysis of the state has long argued, as have neoliberal approaches, that the state is not a neutral administrative body implementing technocratically determined, socially optimal policy (Wagner, 1977). Modern Marxist theories of the state seek to emphasize the integral and functional nature that the state plays in capitalist reproduction without resorting to a deterministic *reductionist* view of the state as a simple “expression of capitalist class dominance” or a *functionalist* approach that “tries to explain phenomena by showing that they meet a need of the capitalist system as a whole or of the capitalist class in particular” (Foley, 1978, p. 224; see also Jessop, 1990). Like the institutionalist approaches, the modern Marxist theory of the state highlights its historical specificity, but rejects the institutionalist’s open-ended indeterminism, with dominant class relations of the economic system playing a defining role in the agenda of the state, which under capitalism is the capital-labor relation.

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<sup>25</sup> See Foley (1978) and Jessop (1990).

<sup>26</sup> This is based on Gramsci’s theory of hegemony and is incorporated more explicitly into a theory of the state by Poulantzas – see Jessop (1985 & 1990).

Within this context, capital with its inherent advantages will generally see its interests reflected in state policy. With respect to fiscal policy, “the problems of capital have created the agenda for the modern state’s expenditures and the conflict between classes and class fractions the primary pressures on state decisions” (Foley, 1978, p. 225). Foley (1978) working within the Marxian framework highlights that most state decisions are not made through election or referendum, with most state policy set outside the political process and political positions formed through intra-party competition, and electoral success linked back to the ability of political parties and candidates to leverage financial support.

In the Marxian framework, individuals are not deemed independent atomistic beings, as they are in the neoliberal framework, but hold identities derived from their class interests, either in a deterministic sense or more realistically as a strong influencer (Davis, 2003, pp. 109-110). Government workers and elected officials may have some agency, but since individuals are embedded in class relations, it is the class struggle which is the prime determinant, as opposed to subjective atomistic individual preferences. A class analysis approach also has normative implications for privatization. When privatization leads to replacing non-exploitative production for use-value by capitalist production methods based on exploitative class relations, this will likely have a negative effect on workers independent of the impact on wages (Cook, 2007).

Like the public choice perspective and institutionalists focused on power, the Marxian theory of the state highlights the role for private interests in shaping policy to extract private benefits at the expense of the broader public interest but adds an additional layer of analysis that informs the prioritization of interests. Specifically, solutions that are advanced to perceived social problems take place within and are shaped by the broader evolving dynamic of the reproduction of class relations, and the specific form that policy solutions take will be shaped by class struggle. Unlike neoliberal theory, which sees all interest groups as relatively equal in a liberal democratic society, Marxian theory highlights the privileged position of private capital in determinants of state policy. This arises

out of the ability of capitalists to withhold and exclude others from the means of production by either shutting down or relocating capital to another jurisdiction. This threat to withdraw capital gives leverage to capitalists over politicians who are more likely to be replaced when economic conditions subsequently deteriorate. Central to the policy development process then will be the imperative to sustain the profitability of capital and avert crises.

The ability and necessity of the working class, within these constraints, to shape policy in a manner which is more favorable to its interests, is contested in Marxian tradition. Some, such as O'Connor (1973), emphasize the necessity of policy to the benefit of the working class, in the form of the welfare state, to resolve the contradictions of capitalist development and facilitate ongoing capital accumulation. Here, class conflict is still the determining factor but the outcome is more functionalist in nature. Alternatively, the "class mobilization thesis" as summarized by Esping-Andersen (1990, pp. 16-17), argues that class conflict does matter in the sense that a stronger working class is impactful, through alliances with other social groups such as farmers, on the degree of social distribution and decommodification through welfare state expenditures, to the benefit of popular classes.<sup>27</sup> Within this social-democratic version of the political competition thesis, the power of the working class and in turn the size of the welfare state is based on its sustainable access to political resources - based on electoral success, trade union density, and alliances - relative to the power of countervailing forces. Duménil and Lévy, (2013, p. 29) utilize a similar class-coalition framework when explaining the shift of alliances that has defined the neoliberal era, with a "popular class" - non-financial management alliance being displaced by a management-finance alliance.

## Implications

The Marxian framework highlights the potential for SIBs, if scaled sufficiently, facilitate reproduction of the social relations underpinning the capitalist system over time. This would be

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<sup>27</sup> See Howell (2003) for a summary of a similar contrast between the *varieties of capitalism* approach, which is focussed on economic governance more broadly and places the needs of firms as the central explanatory factor in policy regime development, and more conflict orientated class-based approaches.

accomplished by advancing financialization, generating profitable capital sinks through privatization, and producing opportunities for the financial sector to recover from its legitimization crisis stemming from its role in the great depression. SIBs do so in a manner that reflects the dominance of capital, relative to a hypothetical alternative based on progressive taxation, limits on financial capital, and the development of universal social programs, an institutional constellation more characteristic of the pre-neoliberal era. SIBs then can be understood as a means to continue to reshape state activity under neoliberalism in favor of the dominant tranches of capital, specifically the financial sector and its beneficiaries.

Dowling and Harvie (2014), for example highlight how the rise of SIBs, as part of the UK Conservative Party's Big Society agenda, is clearly linked to parallel crises of "capital accumulation... social reproduction, and the fiscal crisis of the state" (p. 872). They note the broader social investment market and SIBs in particular, with their focus on quantifying outcomes and converting them into revenue streams for investors, help resolve the social reproduction crisis by providing new profitable sinks for capital while addressing social issues that are hindering the effective reproduction of labor-power, i.e. the health, education, and social development required to produce and maintain current and future workers. Dowling and Harvie then highlight how SIBs and social investment simultaneously take the social value that is produced outside of capitalist relations of production, quantify it, and facilitate its transfer to investors.

Dowling (2017) further extends this research, again focusing on the British context, linking together the UK government's support for financialization, neoliberalism, austerity, and growing anger directed at finance in the wake of the financial crisis and government bailouts of the sector, with a redemptive "social turn" (p. 305) of finance sought in the SIB model. The defensive maneuver is used to "legitimate the further expansion of financial markets... to support continued neo-liberal welfare reform premised upon an austerity agenda... without addressing the structural conditions of social and economic inequality" (p. 305). In the end for Dowling, the SIB, like other social investment



products, hinges on profit being generated, and given its centrality, social outcomes will necessarily be subjugated to profitability, with finance again “privatising gains and socialising risks and costs” (p. 306). Cooper, Graham and Himick (2016) similarly focus on how accounting in SIBs is used to “lay a neoliberal economic grid upon some of the most vulnerable in our society.... effac[ing] their humanity, replacing it with extreme rationality and quantification” while reformulating social value into financial returns. Ryan and Young (2018) echo the above arguments, highlighting the neoliberal tendencies in SIBs, expanding profitable opportunities for capital while further commodifying social reproduction and financializing publicly funded services. They note how SIB projects have in some cases generated an increased reliance on volunteers and led to more precarious working conditions for non-profit staff, advocating for better resourced conventional delivery as an alternative. Joy and Shields (2017 & 2018) building on their previous work, also situate SIBs in this critical framework, as being advanced by economists and business representatives, relative newcomers to the social services scene, advancing marketization of social services and displacing collectivist solutions aimed at addressing the root causes of poverty with individualist behavioralist fixes.

#### IV. Implications for SIB Design and Regulation

In stark contrast to the neoclassical welfare economics underpinning the behavioral modelling of government in our contract theory model constructed in Chapter 4, neoliberal, modern Marxian, and strands of institutionalist theories of the state, all to various degrees, put forward a vision of the state as a collection of institutions that are subject to manipulation by interest groups or classes in a manner contrary to the public interest. Past experience with privatization and contracting out raises concerns that this may be of particular concern for SIBs.<sup>28</sup> Within SIBs where senior public officials are acting in a strategic self-serving manner, there is abundance of motivation amongst stakeholders

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<sup>28</sup> See Chapter 3 Section II.

to design and engage in SIBs where outcome targets are easy to achieve and investors are overcompensated. As summarized by Maier & Meyer (2017), “all key actors will have an interest in setting success thresholds too low and agreeing on excessively generous terms. SIBs would then turn into a funding tool that harms the interest of taxpayers” (p. 7). Investors want SIBs to succeed in meeting targets to recoup their investments, and service providers want SIBs to succeed as failure may have significant reputational effects (Giantris & Piakiewicz, 2013). Public officials who prioritize reputational concerns may be overexuberant in their embrace of SIBs given their abstract popularity and rhetorical attractiveness across the political spectrum (Maier & Meyer, 2017). Loss or failure averse public officials will be more likely to set soft or easily achievable targets.<sup>29</sup>

Given the complexity of the policy instrument and marginal importance of SIBs to the vast majority of voters, it is unlikely that sufficient public attention or pressure will be generated through electoral consequences to ensure that that SIBs are structured in the public interest. As Maier & Meyer (2017) note “very few voters even know what a SIB is. Even fewer voters will be informed about the details of a particular SIB contract. Specific information about SIBs, for example about their transaction costs, is never made public though it might be of interest for taxpayers” (p. 3). This does not necessarily mean a vacuum of accountability. As highlighted by Wittman (1989, p. 1403) government structures such as committees can lead to a highly rigorous examination of specialized government policy and program areas that are incomprehensible and/or uninteresting to the general public, as well as structures that integrate the work of the more specialized forums responsible for annual budgeting exercises that examine aggregate spending composition and projected deficit

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<sup>29</sup> This assumes politicians view an SIB that does not meet targets as a loss or failure and a hitting of targets as a success. See Jervis (1992, pp. 188-192) for an outline of the logic for assuming politicians are loss averse, noting that even relatively small failures can have a disproportionate effect on undermining confidence of the electorate, relative to successes. Alternatively, politicians may view failure as status quo, for example in an all-or-nothing SIB where government does not pay anything to investors if targets are not met. In this case, prospect theory (See: Tversky & Kahneman, 1992) predicts, based on the reflection effect, that politicians would be risk averse over gains, leading again to overcompensation of investors. See Linde and Vis (2017) who describe and find evidence of the reflection effect in an experiment with a sample of Dutch legislators; they do not find evidence of loss aversion but qualify this finding. It is more plausible in our opinion however that an SIB that did not meet targets would be interpreted as a failure given the in-kind resources, associated opportunity costs, and political capital invested. Additionally, despite efforts of proponents to frame the failure in a positive light as a learning experience (see: Anderson & Phillips, 2015; Porter, 2015) reporting on the prominent lack of outcome achievement in the Riker’s Island anti-recidivism SIB was framed by multiple writers as a failure and indicator of ineffectiveness of the model (Chen, 2015; Cohen & Zelnick, 2015; Farmer, 2015).

measures. It is not clear that SIBs will be captured in these former structures unless legislative or regulatory changes are required, and the latter may not see the issue until the SIB investors are paid and deals have been long since negotiated, potentially deferring accountability to well after decisions have been made and possibly under future governments.

Based on the potential for misapplication and obfuscation with the SIB model raised within our three alternative theories of the state, we suggest that increased independent oversight, transparency and accountability mechanisms be implemented regarding government accountability with respect to SIBs. Specifically, we put forward the following three recommendations to aid in monitoring and preempting inappropriate application of the SIB model. First, SIBs should be subject to a transparent cost benefit analysis that compares the relative merits and potential benefits of the model relative to alternative procurement methods, as opposed to rationalizing the model solely based on prospective cost savings or not at all.<sup>30</sup> This should include some accounting for transaction and administration costs that are being covered outside of the formal SIB structure or those committed in-kind. Secondly, if SIBs continue to grow in utilization and spending levels become a more meaningful proportion of government budget, it may be prudent for government auditors to reexamine and develop standard practices for how SIBs are reported in government accounts, particularly if SIBs continue to hit their targets consistently and are repaying investors.

Thirdly, a transparent selection process for investors should be utilized that seeks to achieve competitive rates of return and explicitly accounts for the expected expertise and value-added that investors will bring to improve the effectiveness of social services delivery in the targeted program and policy area. CSR motivation appears to be significant for many investors and it is not clear why government should be paying market-based rates of return to SIB investors when it could be borrowing at below market rates to self-finance projects, particularly if investors are not otherwise contributing to the project. To date many SIBs appear to be constructed, designed and issued in a

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<sup>30</sup> See Chapter 3 for further discussion of this point.

manner that would not stand the test of modern government procurement standards with respect to transparency and competition. New Zealand provides an example of leadership in prioritizing these issues.<sup>31</sup>

## V. Conclusion

While proponents of the SIB model point to new resources and efficiency enhancements, this chapter presents an alternative explanation for the proliferation of the SIB model, that SIBs may be replacing conventional delivery models due to their alignment with well-placed private interests. Available data on the historical development and evolution of the SIB model suggest that a significant proportion of SIBs are hitting their targets and paying out rates of return well above government costs of borrowing. SIBs, however, have continued to proliferate, despite facing high administrative and transaction costs, in addition to the need to pay out returns to investors, which are unlikely to be offset by any induced innovation. One is drawn to seek alternative explanations of SIB emergence and proliferation; we propose the model's alignment with the interests of finance and its consistency with the defining features of neoliberal governance.

This chapter reviewed three stylized economic theories of the state - neoliberal, heterodox institutionalist, and Marxian - that contrast in their assumptions regarding the behavior of public officials in the execution of their duties relative to neoclassical welfare economics, the approach that underlies the model of government behavior in our principal-agent model in Chapter 4. These theories put forward a vision of political behavior based on motives and outcomes not necessarily aligned with the public interest. In this context SIBs may be pursued by governments, even if the SIB delivery mechanism is costlier and less efficient than under traditional delivery.

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<sup>31</sup> See Chapter 2.

Neoliberal theory, relying heavily on the public choice approach, emphasizes how SIBs may be particularly helpful in competition for inattentive voters. Here, SIBs are obscure instruments to most voters that facilitate off-books costs that are difficult to monitor and spread out amongst many voters, but generate new attractive spending focused on prevention that is easier for motivated voters and interest groups to detect, value and potentially benefit from. Public choice theory also highlights the role of interest groups in the process and how they can take advantage of voter inattentiveness, with the alignment of interests between governments, investors and service providers in SIBs potentially leading to overly generous payments with easily achievable targets when these stakeholders are primarily self-regarding. While neoliberal theory in general is supportive of moves such as SIBs towards privatization and market-based solutions, public choice also provides a framework to analyze the rent seeking opportunities such schemes open up, with the theory pointing to the alternative of government not being involved in social service provision at all.

While Marxian theory also highlights the instrumentality of the state to advance sectoral interests, in the Marxian approach not all interest groups are equal, and power is of central concern. Marxian theory emphasizes the dominant role of capital in capitalist societies, and that within capitalism it is the reproduction of the capital-labor relation and the sustainment of profitability that will anchor state activity, not the self-interest of politicians and civil servants. The form state intervention takes will be shaped by class struggle. SIBs in this framework can be understood as a means to continue to reshape state activity under neoliberalism in favor of the dominant tranches of capital, specifically the financial sector and its beneficiaries. We build on these insights in Chapter 7 as we situate SIBs in the broader historical context of neoliberalism.

Heterodox institutionalist theory is mixed in its potential insights and evaluation with respect to SIBs. The Veblen-inspired framework of governance in the interest of large corporations supported by irrational voters with an atavistic affinity for the business class has obvious parallels to Marxian theory as an exploitative view of the state, but other strands of institutionalist thinking have opposing

views. More generally heterodox institutionalists highlight how the underlying behavioral principles of public choice are not reflective of observed reality both in terms of individual behavior and examples of successful state leadership in social and economic transformation. Institutionalists highlight how norms of public service and reciprocity can lead to state decision makers prioritizing the public interest. Combined with the institutionalist evolutionary emphasis on the constructive role for the state as an entrepreneur, coordinator, and mediator, this line of inquiry opens up space for SIBs to be a reasonable organizational approach for social service, as a means for tapping into dispersed knowledge and capabilities. Typical of its indeterminism, the institutionalist tradition at the same time opens up both the potential for SIBs to be a constructive solution while undermining anti-statist approaches that dismiss state-led conventional approaches due to ideological biases.

With respect to the relative merits of each of the above theories, early public choice theory has been challenged on multiple fronts, from both heterodox and mainstream economists, and empirically it has performed rather poorly, with its behavioral assumptions regarding voters and politicians not standing up to testing (Chernomas & Hudson, 2017, pp. 92-105; Kalt & Zupan, 1984; Pressman, 2004). Overall it has been accused of theoretical inconsistencies, resorting to degenerative ad hoc assumptions or substantial reformulation to rescue the theory (Quiggin, 1987). For example, its treatment of government failure while idealizing the market is unbalanced, while other rational choice-based approaches have pointed out that these conclusions regarding the political system are an artifact of the selective assumptions, even with individuals being models as purely self-regarding (Wittmann, 1989).

In this respect the institutionalist and Marxian approaches fare better, partially due to their method of abstraction focusing on moving from the examination of concrete phenomenon to theory, as opposed to a reliance on arbitrary first principles. This methodology helps inform their approaches that are historically grounded and facilitate the examination of diverse institutional arrangements. The degree to which public institutions function effectively in the public interest as

opposed to narrow vested interests, or in Marxian terms, the degree to which progressivity or regressivity involved in the structure will reproduce class relations and conditions of profitability, will vary with historical circumstance (Duménil & Lévy, 2004). The neoliberal period of the last 40 years has been a period of regressive change with respect to growing inequality and increasingly precarious terms for workers on average in most advanced economies, although this change has not been uniformly experienced. In the following chapter we draw on institutionalist and Marxian approaches to identify contextually based factors that have given rise to this differential experience and suggest that SIB emergence is linked to these broader trends.

# Chapter 7: THE POLITICAL ECONOMIC CONTEXT OF SIB EMERGENCE

## Introduction

This chapter examines the broader political economic context of SIB emergence within a combined Marxian and Veblen-inspired heterodox institutionalist framework, two approaches that emphasize historical specificity, power relations, and recognition of the state as a site of conflicting interests. Within this framework, we situate SIBs as arrangements arising due to congruency with the interests of well-positioned classes, specifically finance capital and those who continue to derive increasing wealth from the sector. Our approach is also institutionalist in that it emphasizes institutional variation between countries arising from human agency, circumstance, and path dependence, and highlights how these differences can lead to significant variation in how countries respond to broader global political-economic developments with respect to social and economic policy. Our approach is also Marxian in the sense that we argue that this variation is fundamentally a product of class struggle, but is constrained within capitalist societies, such that the systematic tendencies and crises that capitalist economies generate paired with globalization will shape and restrict governance options and generate patterns and similarities across all developed countries based on their integration in the global capitalist economic system.

Unlike public choice-based approaches founded on methodological individualism, this approach does not rely on a foundation of SIB proponents with conscious motivation to support the interests of finance and its beneficiaries. In fact, we believe that the movement behind SIBs arises from genuine stakeholder concern seeking to address the pressing issue of growing socioeconomic inequality, and



an acute frustration with current systems that neglect the high social returns to preventative investments in poverty reduction and social inclusion. What we are arguing is the modern political-economic structure of advanced capitalist economies, a consciously constructed political ideology and practice aimed at facilitating the restoration of profit and capital accumulation after the crises of the 1970s, has a particular logic embedded in its social structures and institutions that privileges certain solutions over others (Mirowski & Plehwe, 2015). Here there is also clear alignment with Gramsci's concept of cultural hegemony. This approach is consistent with heterodox economics more broadly in asserting that individuals are socially embedded, operating in a structure-agent framework, with institutionally shaped preferences (Davis, 2003, pp. 108-166).

The United Kingdom was the pioneer of SIBs and continues to be a leading nation with respect to SIB development measured by number of projects, with the USA also being a leading developer. As detailed in Chapter 2, together, the UK and US account for 60% of all SIBs launched to date and for approximately three-quarters of all participants and total investment in SIBs. This chapter undertakes a comparative analysis between these countries and two other of the world's largest economies, France and Germany, that have been more cautious and limited in their support and implementation of the model. Germany and France, two countries used in our comparative analysis below, have each only hosted two SIB projects to date. The German projects appear to be relatively small, with only 148 participants in two child welfare SIBs, while France is targeting 1,500 participants in its two workforce development projects. Only one of the four projects, one of the German SIBs, has disclosed its initial investment value, which was less than \$0.5 USM.

Our comparative analysis focuses on the key defining and empirically observed elements of neoliberalism and financialization that have been identified in the literature, highlighting the greater intensity of these trends in the UK and the US relative to Germany and France. This analysis builds upon the fact that neoliberal restructuring has been embraced with varying intensity across

advanced capitalist nations (Kotz, 2017b, p. 32), and the tiered nature of globalized financialization and its spread through global capitalist markets (Lapavitsas, 2013). The US, and to a lesser extent the UK, have led in these regards, while Germany and France to certain extents have been resisters. This analysis also draws on the work of scholars who have identified distinct or ideal-type regimes of accumulation and welfare states across capitalist societies, suggesting that this institutional specificity has some staying power and acts to mediate the impact of broader global political-economic developments and influences.

This chapter proceeds as follows. Sections I and II respectively define the concepts of neoliberalism and financialization, relying on the work of heterodox economists, primarily those working from what we label here as a critical political economy (CPE) perspective.<sup>1</sup> Section IV presents data on several characteristics and indicators illustrating the fundamental structural shifts in mature capitalist nations that have occurred under neoliberal and financialized capitalism, highlighting the differences between our sample Anglophone and continental countries. The structural characteristics and measures reviewed include (a) income inequality, (b) worker benefits and protections, (c) social public expenditures, (d) public provision of goods and services; and (e) financial sector share of the economy. Section VI reviews more recent macroeconomic trends, arising out of the Great Recession of the 2000s and government response, deemed to provide fertile ground for SIBs, including low economic growth, low interest rates, and state fiscal pressures. Section VII explores why the UK, rather than the US, was first to implement the SIB model. Section VIII concludes.

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<sup>1</sup> Political economy is a contested term. It is utilized by those operating in the tradition of the classical political economists, Adam Smith, David Ricardo, Thomas Malthus and their critic Karl Marx whose general framework placed class as the fundamental unit of analysis. Neoclassical and other mainstream economists utilize the term to encompass the imperialist practice within their respective research programs to apply their ahistorical and deductive frameworks based on methodological individualism and instrumental rationality to the study of government and the state. In this chapter we claim the term for the former, with the 'critical' referring to the work of political economists primarily tracing their origins back to and emphasizing the work of Marx. The application in this label in no means aims to diminish the competing perspectives and differences within this broader category, to which, given the scope of this chapter, we will make only limited reference.

## I. Defining neoliberalism

The global economic system has undergone distinct phases of development with varying institutional frameworks governing class relations, managing contradictions and responding to endogenous crises, facilitating waves of capital accumulation (Kotz, 1987). One theoretical approach that relates these phases directly back to profitability and capital accumulation, the central driving force of capitalist development, is the Social Structure of Accumulation (SSA) concept. An SSA is a functional social structure and associated set of institutions that provides stability, managing class conflict and facilitating long waves of robust capital accumulation and growth (Bowles, Gordon & Weiskopf, 1986). Successful SSAs facilitate effort extraction from workers by capitalists sufficient to generate surplus value, realize profits, manage international relations to maintain favorable terms of trade, and ensure state activity, especially taxation and labor law, does not unduly undermine profitability (Bowles et al., 1986, p. 137). SSAs eventually succumb to their internal contradictions and tendencies for the rate of profit to fall over time, generating instability and an increasing allocation of profits into financial sector activities instead of reinvestment in production, with new SSAs emerging in response to crises of profitability (Kotz, 1987). In this manner capitalism goes through discrete shifts in institutional regimes, with relatively brief transitions.

Neoliberalism has been identified as the most recent SSA and described as both the acceptance of a particular logic and a set of institutional structural changes and policy outcomes (Kotz, 2017b). These include: (a) trade liberalization and the elimination of restrictions on international capital mobility; (b) rejection of Keynesian demand management; (c) broad deregulation of corporate activity in production and consumer markets; greater tolerance for monopolistic dominance by industry; (c) reductions in the social safety net; substitution of private for public sector production and enterprise; (d) tax reductions for business and the wealthy; attacks on unions; (e) increasingly precarious working environments for workers; (f) more intense competition both between and

within corporations; (g) an elite class of CEOs that circulate between companies; and (h) a disembedded financial sector with revised product and activity emphasis (p. 42).

Duménil and Lévy (2004) similarly define neoliberalism as a transformation of capitalism, with this transformation reflecting a resurgence of the interests of finance, “a class of capitalist owners and the institutions in which their power is concentrated”, with the objective “to restore... the class’s revenues and power, which had diminished since the Great Depression and World War II” (Duménil & Lévy, 2004, p. 1-2). Financial deregulation, labor market reforms, and globalization, as they have unfolded on neoliberal terms, are subordinate components to this larger project. As with the SSA approach, these changes are spurred by a decline in the rate of profit of enterprise, triggering an endogenously generated structural crisis. Within the above description put forward by Duménil and Lévy, finance is taken not only to include the financial sector proper, but the “complex of upper capitalist classes, whose property materializes in the holding of securities... and financial institutions” (p. 16). In later work, they emphasize the shifting allegiances of the “non-financial and government managers” away from the “popular classes” towards finance as central to understanding this transition (Duménil & Lévy, 2013, p. 29).

Various other definitions of neoliberalism in the CPE approach are broadly consistent with the above descriptions and focus on a shift in structure and institutions of capitalism to reflect a new set of ideas and practices. Harvey (2005) for example, describes the neoliberal shift as prioritizing “a theory of political economic practices that proposes that human wellbeing can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by free markets, private property rights and free trade” (p. 2). The state still plays an important role in Harvey’s definition, managing the money system, enforcing property rights, and constructing markets. As noted by Dowling (2017), Harvey (2003) puts forward some helpful concepts for framing SIBs from a CPE perspective, including “accumulation by dispossession,” (pp. 145-152) based on Marx’s notion of primitive accumulation, where previously external productive

resources are brought into the capitalist sphere of production. This generates “spatiotemporal fixes” (pp. 117-120) for excess money capital in response to an over-accumulation crisis, a description of crises distinct from the more classical Marxian explanations reliant on an endogenous tendency for the rate of profit to fall. SIBs in this framework can be thought of as a distinct form of privatization, privatizing the management and finance of publicly funded social programs, different in kind, if not motivation, from the type of full-privatization that was more common in the early years of the neoliberal era; programs that could not be privatized due to their inability to generate their own revenues without ongoing compensation from the state.

Like Harvey, Mirowski (2015) emphasizes the undiminished role of the state but more heavily underscores its centrality in advancing neoliberal reform.<sup>2</sup> In his 11 tenets of neoliberalism, Mirowski highlights the divergence from classical liberal thought, including: the centrality of the idea that neoliberalism must be constructed and advanced as a political project, requiring an alliance of active interests in academia, public policy, and business circles with a strong managerial state; and a growing acceptance that political democracy is not integral to the neoliberal project, and may in practice be a barrier. This leads to an element of discord where in popular discourse, neoliberal rhetoric centers on democracy, freedom and reduced government, but within the inner circles these concepts are defined with greater nuance and qualification. Mirowski also emphasizes the functional nature of inequality in neoliberal thought, as well as the view of markets as information processors that cannot be outdone by central planning, and the belief that markets can in all cases be constructed to resolve the problems apparently generated by markets themselves. In his later work, Mirowski (2013) makes the explicit link to SIBs as part of a long-term shift by neoliberals from reliance on the state to finance as the source of market-making and innovation. Here, credit-fueled self-betterment is framed as the ultimate source of deliverance from individualized problems arising from the

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<sup>2</sup> This is in contrast to Kotz (2017b), for example, who in some cases appears to equate neoliberalism with classical laissez-faire liberalism or free market fundamentalism (see pp. 86-87), a premise Mirowski explicitly rejects.

growing precariousness of workers under neoliberalism (pp. 350 -355; see also: Cooper et al., 2016). Under SIBs we have similar financialized solutions targeted as fixing supposedly deficient individuals, as opposed to addressing the root systematic causes and social conditions generating these social challenges..

## II. Financialization

The rise of SIBs has been tied by critics to the broader financialization of public services (Lake, 2015; Ryan & Young, 2018; Whitfield, 2015). Financialization can be considered as part of the broader transformation to a “post-industrial’ society” in advanced economies that saw the ascendancy of services relative to industrial goods production (Krippner, 2011, p.2). Like neoliberalism, there exist several but congruent definitions of financialization amongst heterodox political economists. Epstein (2005), working more in the left/post-Keynesian tradition, for example, proposes an inclusive definition of financialization as: “the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies”(p. 3), characterized by “significant increases in financial transactions, real interest rates, the profitability of financial firms, and the shares of national income accruing to the holders of financial assets” (p. 4).<sup>3</sup> This definition is also adopted by Kotz (2017b, p. 33), and a similar definition is proposed by Levitt (2013, pp. 186-188).

Krippner (2005), while acknowledging the multiple characteristics of Epstein’s definition, proposes a more parsimonious definition for financialization: “a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production” (p.181).<sup>4</sup> Lapavitsas (2013), also working more so in the Marxian tradition, defines financialization as a “systematic transformation of advanced capitalist economies” (p. 15) where:

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<sup>3</sup> Although it is clear empirically that a rising real interest rates is not a quality that has persisted through the neoliberal era.

<sup>4</sup> See also Krippner (2011).

non-financial corporations become increasingly involved in and internalize traditional financial sector functions and activities, diminishing the traditional reliance of the productive sector on bank finance; with banks deriving a greater portion of their profits from financial market transactions and household/consumer lending; and with consumers themselves increasingly utilizing credit to meet their essential consumption needs and financial markets for retirement savings and insurance purposes. In an earlier work, Lapavitsas (2012) emphasizes the link between financialization and the growing reliance of the working class on credit for access to the means of subsistence, as the state has withdrawn. As “social provision has retreated in the fields of housing, pensions, consumption, education”, and “access to money increasingly dictates the ability to obtain basic goods” (p.34), he highlights how workers are increasingly vulnerable and victim to financial expropriation through the expenses associated with accessing credit from strategically positioned lenders. Similarly, dos Santos (2012) based on his empirical analysis, demonstrates how these changes that “pushed wage earners onto financial markets as an integral part of their basic reproduction” (p.85), lead to entrenched financial expropriation practices in the US and UK and their expansion to other advanced economies.

While there is some debate regarding primacy, there is a general consensus amongst CPE analysts regarding the concurrent ascendance of finance with neoliberalism, at least in the later years. All of the above reviewed definitions of neoliberalism emphasize financialization explicitly or implicitly to various extents. Kotz (2017b, pp. 33-34), for example, highlights financialization as an important feature, but argues that it at best has second-order explanatory power, as the rise of finance was due to the financial deregulation spawned by neoliberal reforms, and the sector did not significantly expand its share of profits until the 1990s. Duménil and Lévy’s (2005) definition of neoliberalism on the other hand directly assigns central prominence to the resurgence of the financial sector, defining

neoliberalism as a product of financialization and stating that “most, if not all of the Left now agree that neoliberalism is the ideological expression of the reasserted power of finance” (p. 17).<sup>5</sup>

In addition to these Marxian-inspired analysts, the monopoly capital or *Monthly Review* school, has embedded financialization as a core concept of its depiction of the current stage of capitalism, now referred to in the framework as *finance-monopoly capital* (Foster, 2007). In the left/post Keynesian school, Epstein refers to the era since the mid-1970s as one of “profound transformation ... characterized by the rise of neoliberalism, globalization, and financialization” (p. 3), with post-Keynesian authors more broadly being active in analysing the ascendancy of financialization, drawing upon Keynes’s critique of rentiers, emphasizing policy choice as opposed to endogenous crises of the Marxian variety (Lapavitsas, 2013, pp. 29-33).

The consensus amongst critical political economists also extends to the consequences of financialization, particularly in the exemplar of the United States. The increasing size of the financial sector has been observed according to various indicators, including the value of financial assets relative to net worth of the non-financial sector, and the share of finance in GDP, leading to rising inequality, more intense crises, and tepid accumulation/economic growth in advanced economies.<sup>6</sup> Faced with a relatively stable economy-wide rate of profit over this period of growth, finance has managed to capture an increasingly large share of profits, in addition to a growing share of skilled labor at the expense of the real economy (Kneer, 2013). The increasing reliance of the productive sector on internal finance and the ballooning financial liabilities of the household sector relative to GDP has also been dramatic.<sup>7</sup> After exhausting the ability to maintain a targeted, socially determined

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<sup>5</sup> Levitt (2013, pp. 186-188), while accepting Kotz’s timelines, holds a similar view, elevating “The Great Financialization” (p. 186) as the source of the displacement of the golden era, decoupling capital from national interests and confinement, unleashing capital and crises around the globe, and undermining the discretion of the state while ushering in a host of neoliberal reforms.

<sup>6</sup> For a relatively recent review and discussion of these subsequent indicators of financialization referenced here, see Lapavitsas (2013, pp. 205-244).

<sup>7</sup> Lapavitsas highlights that while finance may be predatory, he argues it is not parasitic, with the financial system an essential component of an advanced capitalism. He differentiates between two distinctive sources of financial profits, those arising through expropriation and those arising as a share of surplus value realized (p. 151). While there are contradictory forces at play regarding the value of finance to productive enterprise, he argues that the exploitation that takes place through financial transactions between workers and capitalist firms are “exploitative... but qualitatively distinct from exploitation in production” (p. 143). Baragar and Chernomas (2012) however demonstrate that exploitation through the financial system does effectively raise the rate of exploitation as traditionally understood, but



standard of living though increases in household labor supply, financialization permitted a significant component of the working class to maintain living standards through increasing debt, despite facing a prolonged period of stagnant or declining real wages since the 1970s (Saltis, 2011). The financial crisis simultaneously removed this stop-gap measure of debt-financed consumption, thrust a large mass of workers into unemployment, insolvency, and highly precarious circumstance, generating a populist backlash against the financial industry and a scramble by political leaders to resolve the crisis and restore legitimacy to the prevailing economic system.

The subsequent rescue of the financial industry with minimal support for the population more broadly was only the most acute example of finance's reliance on the state at the expense of the wider population.<sup>8</sup> This post-crash environment, with finance and the state facing a legitimization crisis, the growing fiscal crisis of government, and social-economic inequality becoming an increasingly salient topic of popular discourse, was the environment of SIB emergence. This appearance of a financialized solution to a crisis of financialization links directly to Mirowski's definition of neoliberalism, but the parallels of SIB securitization with the very instruments that triggered the financial crisis still gives one pause. Cooper et al. (2016) draw attention to this in reference to a specific homelessness prevention SIB: "in the same way that individuals, securitized as mortgage holders in mortgage-backed securities, become particular market risks according to their payment and default patterns, homeless individuals' life experiences are now part of a pattern of risk to investors in the SIB scheme" (p. 80). But in the case of SIBs, rather than relying on the implicit guarantee of the state underwriting risky behavior, government payment of investor returns is built directly into the model. SIBs then, from this perspective, are an evolution of the growth of finance and its heavy reliance on the state, deepening the "vast public subsidy to the financial system characteristic of financialization" (Lapavitsas & Mendieta-Muñoz, 2016, p. 49).

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the resulting surplus value materializing as profits is not generally to the benefit of the productive capitalists, abstracting away from aggregate demand and credit market effects.

<sup>8</sup> See Lapavitsas & Mendieta-Muñoz (2016) for discussion of state support for the financial sector over the neoliberal era.

### III. Comparative Analysis of SIB Leaders and Followers

SIBs fit well with the larger structural changes of neoliberalism and financialization, but not all countries have embraced these trends with equal enthusiasm. Below we compare a series of indicators demonstrating this diversity for two sets of countries. The first group is the US and UK, leaders in SIB implementation, with strong and relatively longstanding support for the model from the national governments. The second group is France and Germany, two countries that have ignored or resisted SIB implementation for the most part, with a small number of projects and minimal to no government support or leadership.<sup>9</sup>

While the above summaries of neoliberalism and financialization discuss the concepts in qualitative terms, this section examines the empirical evidence of structural change in greater detail. Within the CPE perspective, the outcomes of capitalist development and policy regimes are not technologically determined but are subject to the outcomes of social forces, with class conflict between capital and labor being central to the institutional specificities in various countries. Within this heterodox framework, the reproduction of capital and accumulation are paramount, but state policy is not a deterministic reflection of the interests of capital; end outcomes will be shaped by class struggle (Foley, 1978).<sup>10</sup> Esping-Andersen's modified class mobilization thesis (1990, pp. 16-17), for example, suggests that in this framework a stronger working class will impact the degree of social distribution and decommodification through welfare state expenditures, based on the degree to which it can leverage trade union density and alliances, particularly with farmers' movements, to generate a social democratic welfare state.

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<sup>9</sup> SIB proponents have noted that in "certain European countries, developers encountered resistance, finding the sentiment that the type of social issues targeted should be the domain of the state and that a private investment model has no role to play, or that it is inappropriate for investors to receive a return on investment from financing the delivery of social outcomes" (Dear et al., 2016, p. 43). France, for example had publicly stated its hesitancy to adopt the model due to privatization concerns (Mair, 2016).

<sup>10</sup> See also Duménil and Lévy's (2004) discussion of progressive versus regressive means of restoration of the rate of profit.

There are a number of classification frameworks that have been developed over time through the examination of the socio-economic policy regimes in western advanced economies. Specifically in regard to social policy, Titmuss (1974, pp. 30-31) suggests three categories: the “industrial achievement-performance” model which primarily linked benefits to labor market history and aligns with continental European models; the “residual welfare state model” based on a minimalist approach, typical of the United States for example; and the “institutional-redistributive model” which was more extensive and based on universal social programs, with Scandinavia being the exemplar. Esping-Andersen (1990) utilizes three categories that align similarly to classify welfare states into regimes, including “conservative, liberal and ‘social democratic’” (p. 3) based on how “welfare production is allocated between state, market, and households” (Esping-Andersen, 1999, p. 73). In general, the conservative and social democratic welfare states both provide high levels of income replacement, while the social democratic model is distinguished by its universalism and its focus on decommodification of service delivery through public delivery (Esping-Andersen, 1999, p. 79). Conservative welfare regimes are also distinguished by lacking support facilitating women’s participation in the workforce and their tiered benefit structures which reinforce status hierarchies between occupations.<sup>11</sup> Liberal regimes rely on lower levels of welfare spending and redistribution with targeted benefits based on means-testing, although over time have also come to rely on refundable tax credits for low income workers with labour market earnings (Esping-Andersen & Myles, 2011, p. 646). Reforms since the 1970s have reduced the differences between countries within Esping-Andersen’s social democratic and conservative groupings, leading to a more clear contrast between the Anglo-Saxon liberal regime type and the social models of western Europe (Danforth, 2014).

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<sup>11</sup> For an updated empirical analysis of the clustering of countries into Epstein-Andersen’s classification scheme, see Danforth (2014), who finds continued relevance of the scheme once additional measures are explicitly incorporated in to the empirical analysis, including those related to women’s participation in the workforce, income redistribution, and active labor market programming.

Gordon (1994) examines how management regimes, particularly in relation to the emphasis on supervisory labor relative to more cooperative forms of workplace governance, have discrete variance between countries, with for example the US relying on high ratios of supervisory labor to production workers and high cost of job loss, while Western European countries are characterized by lower measures of both these variables.<sup>12</sup> The more recent *varieties of capitalism* approach similarly distinguishes between two forms of broader economic governance regimes, “liberal market economies and coordinated market economies” (Hall & Soskice, 2001, p. 8), with the former relying primarily on market competition, authoritarian within-firm labour management and flexible labor markets, and the latter more so on institutionally coordinated inter and intra-firm planning and negotiation between stakeholder groups. Within this framework, Hall and Soskice emphasize the complementarities that develop between institutions and organizations within each framework that sustain distinct regimes over time and suggest that this leads to a relativism with respect to effectiveness of particular organizational innovations.

Drawing loosely on the above regime classification approaches, below we demonstrate clear differences with respect to the structural characteristics of our two sample Anglophone countries relative to their two western European counterparts. Throughout we suggest how these differences create a more fertile ground for the development of SIBs in the UK and US relative to France and Germany, providing a historically and institutionally rooted alternative explanation to the efficiency-based explanations of SIB emergence. As with any classification approach, one must be cognisant of diversity within the categories and the nuance that is lost. For example, the UK’s displaced social democratic tradition and history of labor participation in the construction of the welfare state, along with its continuing universal national health service, fundamentally distinguishes it from the US, despite both being classified as liberal market regimes (Esping-Andersen, 1999, p. 73-77). Regimes can also shift over time. The UK for example in the post-war period was one of the more social

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<sup>12</sup> See also Kleinknecht, Kwee & Budyanto (2016).

democratic states, and reforms over the neoliberal period have reduced the differences between Esping-Andersen's social democratic and conservative groupings (Danforth, 2014).

## a) Income Inequality

SIBs have arisen in a context of historically high levels of income inequality and have proliferated as economic inequality has grown in salience as a topic of public policy discourse since the recent economic crisis. Higher income inequality has been associated with a number of negative economic, social and political outcomes, including reduced economic growth, lower educational and skills attainment, negative population health outcomes, and increased violent crime (Berg, Ostry & Zettlemeier, 2012; Cingano, 2014; OECD, 2014; Thorbeck & Charumilind, 2002). Higher income inequality has also been demonstrated to reduce inter-generational income mobility, undermining liberalism on its own terms (Corak, 2013; Stiglitz, 2013). Since the mid-1980s income inequality has increased significantly within OECD countries), and the disparity between the incomes of the richest and lower classes for many advanced countries, in particular Anglo-Saxon countries, has returned to levels not seen since the early 20<sup>th</sup> century (Piketty, 2014).<sup>13</sup> These trends are also apparent in our sample countries. Higher income inequality may support SIB development as it generates greater social ills requiring remediation and higher disposable income for higher income earners, leading to greater pools of available funds seeking investment opportunities either directly or through philanthropic organizations.

Below we present two measures of income inequality, illustrating, for the most part, the significantly higher levels of income inequality in the US and UK relative to France and Germany, and

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<sup>13</sup> Based on calculations from data in OECD (2018), economic inequality, as measured by the population post tax and transfer Gini coefficient, increased in 15 of the 16 countries for which data is available, with an unweighted average increase of 12.7% between 1983-1986 and 2009-2012. Countries were included in the sample if they had at least one data point in each of the four-year time periods. This includes Canada (7.9%), Denmark (11.1%), Finland (25.9%), Germany (15.3%), Greece (-4.9%), Israel (15.2%), Italy (9.8%), Japan (10.3%), Luxembourg (11.3%), Mexico (4.8%), the Netherlands (3.4%), New Zealand (19.4%), Norway (11.6%), Sweden (36.9%), the United Kingdom (10.9%), and the United States (13.7%). The average increase for Australia was 7.2 percent between 1995 and 2010-2012.

increasing income inequality over time. The top 10% income share, before taxes and transfers, is presented in Figure 9. Between 1992 and the Great Recession, the UK and US had higher levels of inequality, with the top 10% of earners capturing 43% and 46%, respectively, of total income in 2007, relative to 40% in Germany and 34% in France. Germany and the UK more recently appear to have converged, although the available data series for Germany is truncated, while the US and France maintained their disparate positions. All countries, with the exception of France, saw significant growing inequality over this time according to the top 10% measure.

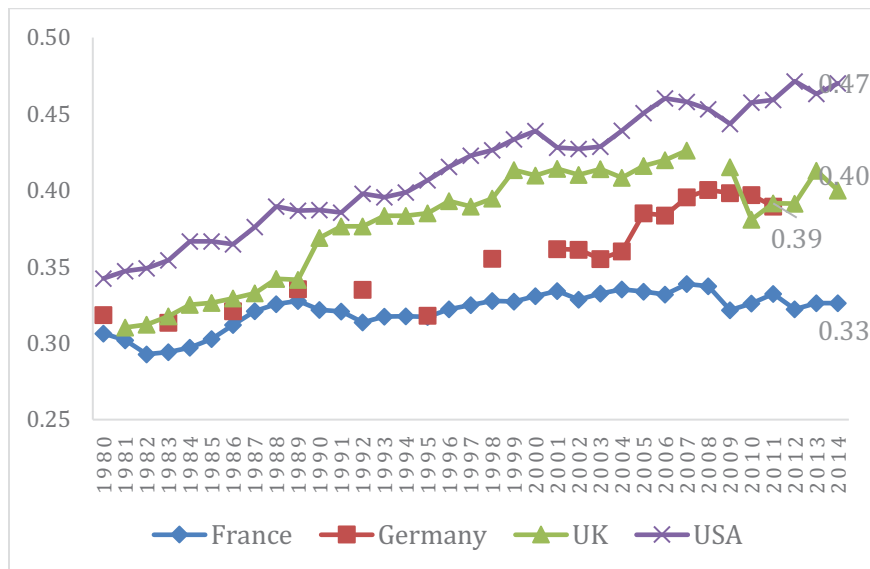


Figure 9: Pre-tax income share of top 10%, 1980-2014. Data from Alvaredo, Atkinson, Piketty, and Saez (2017).

The Gini coefficient for these countries, a less intuitive but more comprehensive measure of income inequality, is presented in Figure 10, based on income after accounting for redistribution through tax and transfers.<sup>14</sup> By this measure, income inequality was approximately 18% higher in the UK and 28% higher in the US, relative to Germany and France in 2007, with France and the UK

<sup>14</sup> The Gini coefficient is an index from zero to one, with zero representing complete equality and one being absolute inequality with one household having all income.

continuing to see increases over the following four years, and the UK and US maintaining levels well above their European counterparts. By both measures then we can see that inequality has been more pronounced in the US and UK relative to Germany and France in the neoliberal era, suggesting a more fertile environment for SIBs in the UK and US.

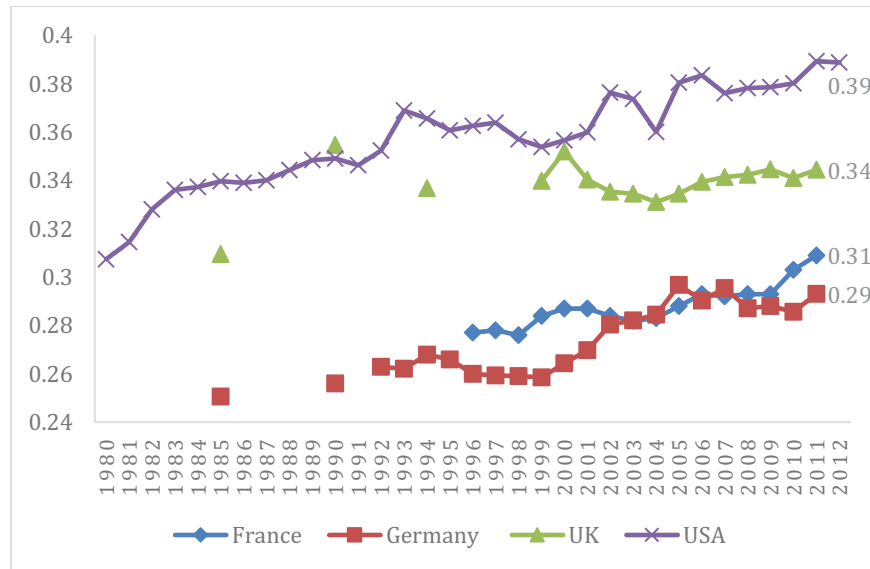


Figure 10: Gini coefficient based on disposable income, post taxes and transfers, 1980-2013. Data from OECD (2018).

## b) Pre-distributive Policies

One can imagine two broad categories of government action that can influence the distribution of income within countries. The first is the setting of the economic, legal and institutional framework governing the property rights and relative bargaining power between workers and those who rely primarily on their ownership of capital assets to generate income. This category of pre-distributive policies includes legislation governing unionization, minimum wages and dismissal practices. The second are redistributive measures through social public expenditures, including direct redistribution through the tax system and entitlement benefits, as well as in-kind redistribution through the delivery of social programs. The state can also encourage voluntary redistribution through incentives such as charitable tax credits, etc.. After tax and transfer income distribution

therefore can be thought of as arising from the income shares derived from production and the redistribution of those incomes after the fact. This section explores differences in the within-workplace institutional context, while the next explores redistributive measures.

Prominent economists have put forward competing explanations of the increases in inequality and the growing precariousness of the working class more broadly, the latter referring to the reduced quality of work resulting from a combination of low wages, weakening attachment to employers, growing underemployment, and increased irregularity of employment, along with weakening access to unemployment benefits.<sup>15</sup> Some mainstream economists have argued that technological change has been the driving factor behind the increasing income inequality, particularly in the US, with the demand for skilled workers increasing while the relative growth in educational attainment has slowed (Goldin & Katz, 2007a, 2007b). Others within the mainstream have critiqued the skill-biased technical change explanation, arguing that it is inconsistent with the data, and that declines in the unionization rate and minimum wages have played a greater role (Dinardo & Card, 2002; Freeman, 2005; Stiglitz, 2013, pp. 81, 303). Heterodox economists such as Kotz (2017b) and Howell (2013), and left-liberal economists such as Stiglitz (2013), primarily in reference to the US economy, emphasize that through a relatively generous and labor-friendly institutional structure, in historical terms, post-war workers managed to secure real wage gains as productivity grew. However, beginning in the late 1970s, an aggressive restructuring of the state in favor of capital led to removal or weakening of labor-friendly policies, such as minimum wage and union recognition requirements, paired with increased international competition and the globalization of production. This led to decoupling of real wage growth from productivity gains and stagnant real wages for workers overall and growing inequality. The deregulation of labor markets and reduction in access to unemployment benefits have been trademark policies of neoliberal governments.

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<sup>15</sup> Marxian scholars have long highlighted that precariousness is integral to the operations of capitalist accumulation and an enduring condition of working class existence in capitalist societies, embedded in the reserve army of labor concept. See Jonna & Foster (2016) and references within.



Measures of collective bargaining coverage, minimum wage, and worker protections are likely to factor into the ability of SIBs to take root and spread in a particular country. As a general reflection of the bargaining power of labor, these measures may proxy as a degree of resistance that labor can mobilize to counter privatization movements more broadly. High unionization and minimum wage rates will also narrow the cost gap between public versus private provision, limiting the cost savings potential of SIBs over more traditional delivery models. The high levels of expenditure on unemployment benefits may however have a countervailing effect, acting as an attractive source of profitability and cost saving. This is equally applicable to growing social public expenditures in general.

Table 12 below presents data on collective bargaining coverage. By this measure, the collective bargaining power of labor relative to capital continues to erode for all of our sample countries with the exception of France, as evidenced by continued declines in the proportion of the labor force covered by collective agreements, a trend representative of the broader set of OECD countries.<sup>16</sup> France has the highest with a consistently elevated rate of approximately 98% in the years surrounding the crisis, while Germany's rate has fallen from 85% in 1980 to 58% in 2013. This however is still almost double the rate in the UK, which was just under 30% in 2013, and more than five times the rate in the US in 2013, which was just over 11%.

These differences are similar to the varying degrees to which these countries instituted employment protections for workers. The OECD's index of strictness of employment protection related to individual and collective dismissals, which provides a numerical representation of the regulatory restrictions around hiring and firing of employees, shows Germany, France and the UK respectively having measures nine, eight, and four times more restrictive than the US, (OECD, 2018).

Table 12

<sup>16</sup> Trade union density decreased on average in OECD countries by 6.1 percent between 2009 and 2013 (OECD, 2018).

<i>Percentage of Employees with Collective Bargaining Coverage</i>			
<u>Country</u>	<u>1980</u>	<u>2008</u>	<u>2014</u>
France	77	98	99
Germany	85	61	58
UK	69	34	28
USA	25	13	12

Note: Data from OECD (2018).

Figure 11 presents data on the real value of the minimum wage in the four sample countries. France has seen its real minimum wage trend upwards since 1980, while the US saw a drop in the early 1980s then fluctuated at a low level since. In 2007, the French real minimum wage was 70% higher than the US, with the gap closing since but then trending apart recently. The UK and Germany did not introduce minimum wages until 2000 and 2015 respectively, with the UK level below that of the US upon introduction, and Germany being about 8% below France.

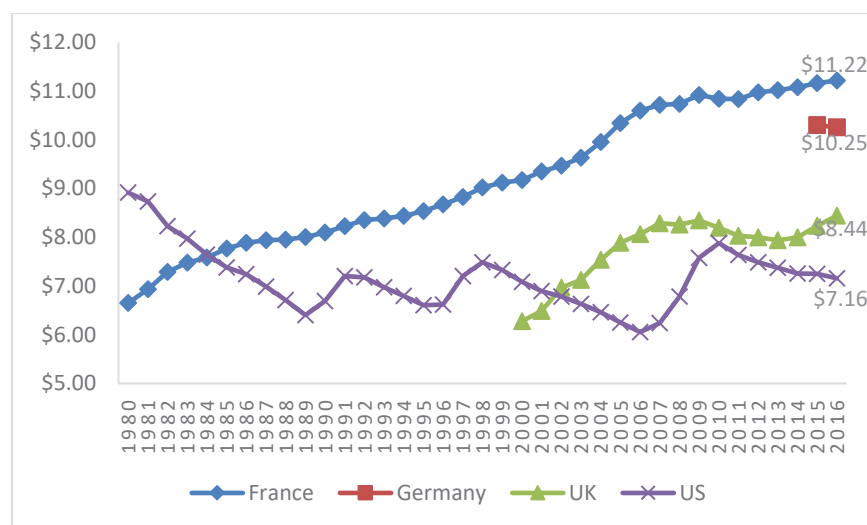


Figure 11. Real hourly minimum wage in 2015 US Dollars converted using the purchasing power parity method, 1980-2015. Data from OECD (2018).

Figure 12 presents data on the percentage of GDP allocated to out-of-work income maintenance benefits. These benefits are partially a redistributive measure, but also increase the bargaining power of labor by reducing the cost of job loss. While demonstrating cyclical variation, there is a clear discrepancy between the level of income protection provided to workers in our Anglophone

countries relative to Germany and France. In 2006, spending in Germany and France on unemployment benefits was approximately seven times higher than in the UK and the US. While Germany has trended downwards recently relative to France, both countries remain significantly more robust with respect to expenditure on income replacement.

All three of these measures of worker protection reinforce our classification of the US and UK as more wholeheartedly embracing the neoliberal model and in turn an environment supportive of SIBs.

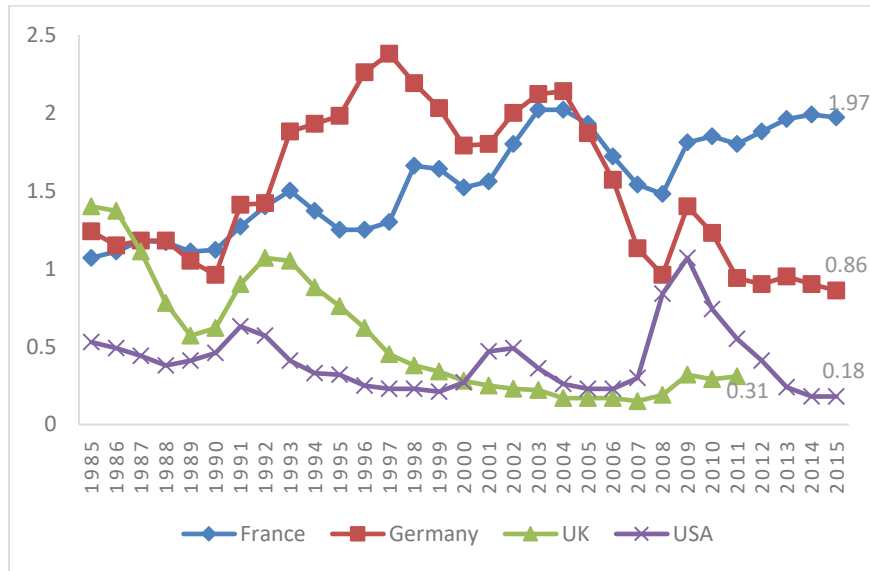


Figure 12. Public Expenditure on out-of-work income maintenance and support, as a percentage of GDP. Data from OECD (2018).

### c) Redistribution through Tax and Transfers

In addition to impacting income distribution through the regulation of labor relations and work, governments redistribute income through taxation and social public expenditures (SPE). Redistribution has mixed impacts on the environment for SIBs. Greater redistribution and social service entitlements reduce inequality, leading to an amelioration of the negative social consequences noted above, and a decrease in the urgency and motivation to devise new social models of interventions. However, as SPE grows as a proportion of government expenditure and is increasingly delivered in-kind through services as opposed to cash benefits, within the CPE

perspective, it becomes an increasingly attractive target for private investment, if structures such as SIBs can be instituted.

Figure 13 presents data on marginal tax rates on the highest income earners. While the US and UK had more progressive income tax rates in 1980, and in the post-crises period the UK briefly hiked their rates above Germany and France, the trend for most of the sample period is one of more progressive rates in the two European countries, with higher top income tax rates in France and Germany relative to the UK and US from 1988 to 2009.

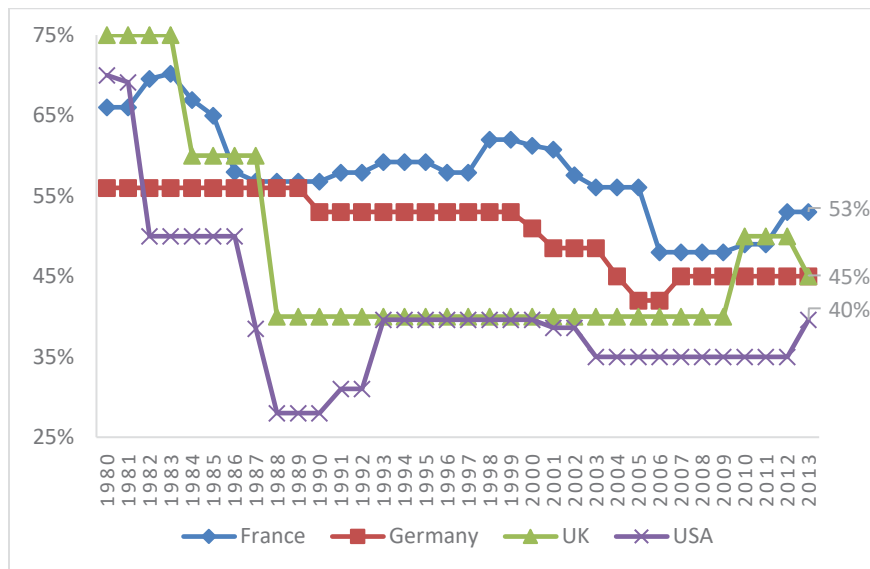


Figure 13. Top marginal income tax rates, 1980 to 2013. Data from Piketty (n.d.).

Table 13 presents data on SPE for each sample country as a percentage of GDP.<sup>17</sup> SPE can be considered a broad measure of social safety net expenditures and includes spending on income supports for survivors and the elderly, disability-related benefits, healthcare, family allowances, labor market programming, unemployment benefits, housing, social assistance and food subsidies.

<sup>17</sup> The OECD defines social expenditure as “benefits to, and financial contributions targeted at, households and individuals in order to provide support during circumstances which adversely affect their welfare, provided that the provision of the benefits and financial contributions constitutes neither a direct payment for a particular good or service nor an individual contract or transfer.... only benefits provided by institutions are included” (Adema, Fron & Ladaique, 2011, p. 90). For spending to be considered “social”, the programs need “to be intended to address one or more social purposes” and entail “inter-personal redistribution” or “compulsory participation” (p. 90). Social expenditures are considered “public” when the “financial flows [are] controlled by General Government” (p. 93).

At least three features of this data are notable. First, France and Germany continue to exhibit larger interventionist and redistributionist tendencies than the US and the UK, with a significantly larger share of economic output committed to social public expenditures. Secondly, SPE has increased significantly in all of our sample countries from 1985 to 2006 according to this data. Finally, all of the countries increased SPE after the recession, as would be expected, but continue to be well above their pre-recession levels in 2016, with the exception of Germany, which has been the most stable over time.

Table 13				
<i>Social Public Expenditures as a Percentage of GDP</i>				
<u>Country</u>	<u>1985</u>	<u>2006</u>	<u>2010</u>	<u>2016</u>
France	25.2	28.1	30.7	31.5
Germany	22.2	25.0	25.9	25.3
UK	18.2	19.2	22.8	21.5
USA	12.8	15.7	19.3	19.3

Note: Data from OECD (2018).

Total social public expenditures can be divided into benefits that are paid out as cash benefits, either as direct payments or tax credits, and those that are delivered in-kind through various programs. Social expenditures delivered in-kind include services such as healthcare, education, childcare, subsidized housing, and components of active labor market programming, including, for example, training programs and sponsored work placements for the unemployed. In-kind service delivery is more relevant for the present analysis, as SIBs to date are being utilized primarily for the delivery of in-kind social benefits.<sup>18</sup> Figure 14 outlines the percentage of in-kind benefits and active

<sup>18</sup> Cash benefits generally entail entitlement expenditures such as old age and survivors' benefits that are insurance-like in nature, where income replacement is the primary and end objective of the program. In-kind expenditures are more likely to be focused on specific outcomes with their own metrics and targeted outcomes beyond the delivery of the service, such as returning people to good health, integrating the unemployed into sustainable employment, and improving school readiness for young children. This categorization however is not purely discrete. For example, cash child benefits are more likely to be motivated by offsetting the impacts of child poverty and improved early childhood development outcomes as opposed to compensating parents for lost income. Similarly, the longer-term goal of unemployment benefits paid in cash is presumably to provide stability, so workers can reintegrate into the employed workforce, in addition to income replacement.

labor market programming as a proportion of total SPE in the sample four countries from 1986 to 2013.<sup>19</sup> The UK and the US have consistently had a larger share of SPE delivered in-kind, and in recent years has been stable at approximately half. In all countries, the in-kind plus ALMP portion has been trending upwards over this period, with the exception of France which saw a similar trend only until the late 1990s, then saw the in-kind plus ALMP proportion begin to decrease afterwards. has seen a recent reversal, suggesting a growing proportion of SPE that fits best with the SIB model.

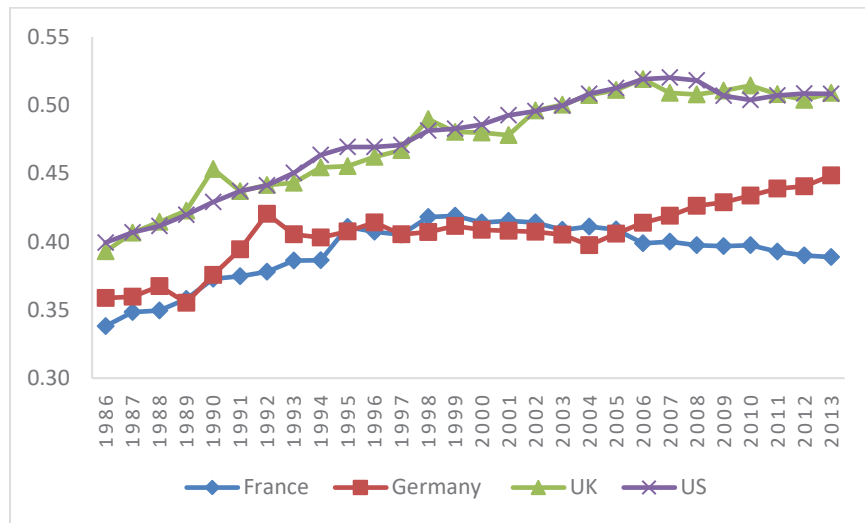


Figure 14. In-kind and active labor market program social public expenditure, as a percentage of total social public expenditure. Data from OECD (2018).

#### d) Privatization and Public Provision

Privatization is a hallmark of the neoliberal restructuring of the state, and several of the relative cost critics have connected the rise of SIBs with empirical studies of privatization demonstrating ambiguous impacts on costs and declining service quality (Fraser, Tan, Lagarde & Mays, 2018, p. 14-15; Warner, 2013, p. 5; Whitfield, 2015). Below we present three indicators on the role of public versus private provision. The first relates directly to production methods, while the second is only indirectly related to production but corresponds directly to social service provision. The third is the

<sup>19</sup> While active labor market programming is included in total SPE, the OECD Social Expenditure Database does not classify it as either an in-kind or cash benefit.

broadest measure of government spending, total general government expenditures as a proportion of GDP. We suggest that countries with a greater acceptance and practice of public sector provision are more likely to support public provision or conventional procurement and be skeptical of the SIB model.

Table 14 presents data on the proportion of the labor force employed in public enterprise. The data from 2001 to 2011 is from the *OECD Stat* database (2018), while the 2012 data is from the OECD (2012) *Dataset on the Size and Sectoral Composition of National State-Owned Enterprise Sectors* and is based on a survey response, so the data is not directly comparable. Both sets of data point to a larger state-owned enterprise sector in France and Germany relative to the US and the UK. This is consistent with historical narrative of privatization in the west, with the lack of state owned enterprise in the US historically, the broad and significant privatizations that took place in the UK under Prime Minister Thatcher, and the still intensive but less dramatic set of privatizations that followed in Western Europe.

Table 14				
<i>Percentage of the Labor Force Employed in Public Corporations</i>				
<u>Country</u>	<u>2001</u>	<u>2005</u>	<u>2011</u>	<u>2012*</u>
France	3.3	2.5	2.5	5.0
Germany	4.7	3.7	3.7	2.6
UK	1.3	1.3	1.7	0.8
USA	.	.	.	0.2

Note: Data for 2001 to 2011 is from OECD (2018) and refers to employment in public corporations as a percentage of the labor force.  
 \*Data for 2012 is based on a survey undertaken by the OECD (2012) for the Dataset on the Size and Sectoral Composition of National State-Owned Enterprise Sectors and is therefore not directly comparable with other years.

Figure 15 presents the second indicator, data on voluntary private social expenditure as a proportion of total social expenditure. Here also France and Germany are significantly more reliant on public social services relative to private provision. While Germany and France have in more recent

years covered approximately eight percent of social expenditure through voluntary private funds, in the UK it is double and the US four times that proportion.

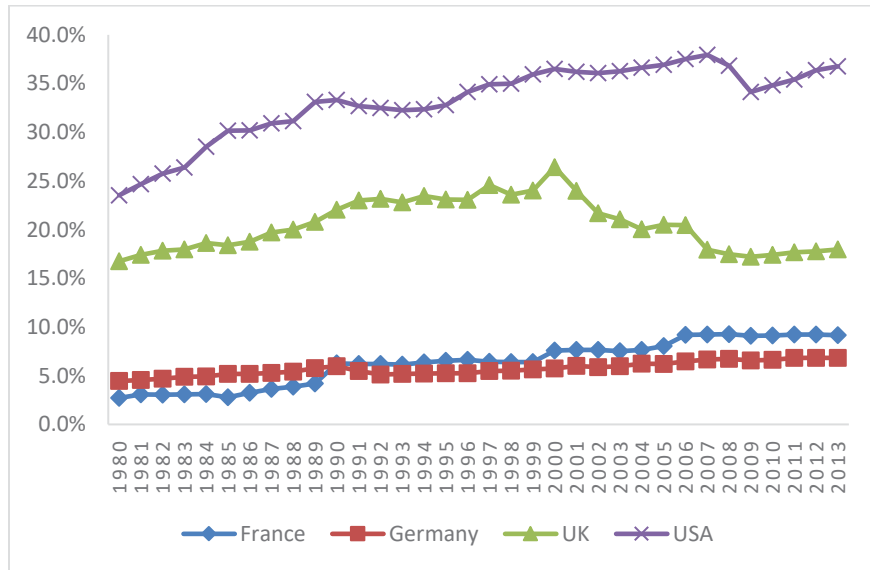


Figure 15. Voluntary private social expenditure as a proportion of total social expenditure, 1980 to 2013. Data from OECD (2018).

Finally, Figure 16 depicts data on total general government spending, which includes all three levels of government and social security funds, as a proportion of GDP. In 1995, France and Germany government expenditure accounted for approximately 54% to 55% of GDP, while the UK and US were in the 37% to 39% range. Throughout the 1995-2005 period Germany and France maintained distinctively larger public expenditures relative to the UK and the US. While Germany and the UK have since converged and tracked each other after the economic crisis, France has remained at its high level and the US at its relatively lower level.



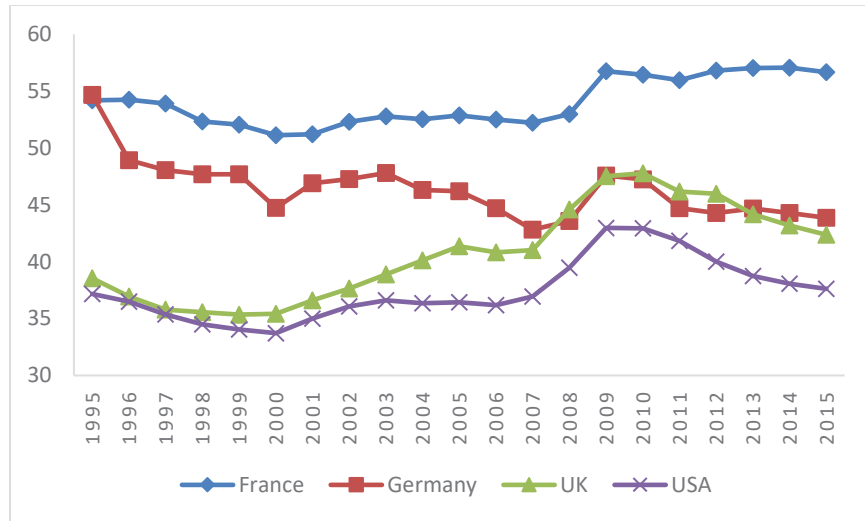


Figure 16. General government expenditure as a proportion of GDP 1995 to 2015. Data from OECD (2018).

#### e) Size of Financial Sector

SIBs, in particular those leaning heavily on self-financing from future social expenditure savings generated by preventative service, are a financial innovation in the sense that they allow the government to borrow from these future savings to finance current programming. The expertise to develop such instruments is not naturally found within government, and in practice they have relied on the financial sector to provide this expertise. Deloitte, Ernst and Young, and KPMG have all been active in providing technical assistance and/or evaluation services on SIB projects. Investment and banking firms, including Tridos Bank and Bridges Fund Management in the UK have been leaders in the establishment of SIBs, going beyond simply investing in projects but actively managing them as the intermediary. Bridges Fund Management and QBE Insurance Group have established dedicated investment funds targeted at SIBs and Pay for Success projects. Bank of America Merrill Lynch and Goldman Sachs have acted as placement agents and mobilized investors for SIB projects, with Goldman committing their long-term support despite their involvement in the single known SIB to date that did not repay its investors. As previously noted, SIBs convey a number of benefits to the financial sector including healthy returns along with a corporate social responsibility effect. All of

this points towards a well-developed financial sector being a contributing factor to the emergence of SIBs.

Following Baragar and Chernomas (2012) and Lapavitsas (2013), Figure 17 below presents data on the size of the financial and insurance sectors with respect to its contribution to GDP,<sup>20</sup> with the qualifier that the CPE approach does not recognize these sectors as generating value in production, but a means of redistribution of surplus value after the fact. These sectors enter GDP through their inputted value-added measured as a value of output minus the value of inputs, as opposed to a direct measure of real value added, as these industries do not sell a tangible good or service that can be objectively measured and are intermediate outputs themselves. While misleading as a measure of contribution to output in the CPE framework, the share of the financial sector in GDP can be used as a metric representing its size in relation to other sectors.

Figure 17 shows clear differences between the two sets of countries. From 1997 to 2006, the financial sectors in the UK and the US increased their shares of GDP by 30% and 13% respectively, while France and Germany saw minimal growth of 1%. In 2006, the financial sectors in the UK and the US were nearly 75% larger as a proportion of the economy than in Germany and France. While the financial crisis generated significant fluctuations, the US and UK sectors have remained consistently larger than in France and Germany. This is reflective of the broader finding that the global rise of the Anglo-Saxon model of capital market-based models of financing accumulation, while a defining feature of financialization, has not been embraced with universal enthusiasm and its penetration has varied (Lapavitsas, 2013, pp. 133-137).

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<sup>20</sup> This is a limited measure of financialization as it does not account for increasing finance-sourced profits within manufacturing firms and also does not account for any increase in outsourcing of finance activity to financial firms: See Krippner (2005) for a more sophisticated approach for measuring the degree of financialization, the challenges of such an exercise and how to account for these issues.

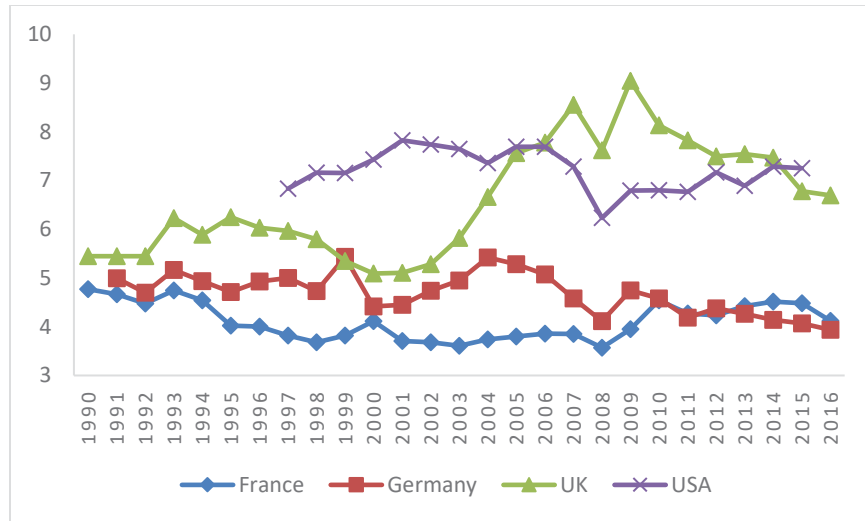


Figure 17: Finance and insurance sectors as a percentage of GDP, 1990 to 2016. Data from OECD (2018).

#### IV. Post-crisis Context

In addition to the longer-term trends reviewed above, there were and continue to be pressures and consequences arising from the 2008-2009 economic crisis that create additional incentives for the state and the financial institutions to pursue SIBs and more generally seek new investment opportunities for latent capital. These include low economic growth rates, low interest rates, and increasing fiscal pressures on the state.

As noted above, neoliberalism has been characterized by low economic growth rates relative to the preceding Golden Era. Table 15 highlights this fact and demonstrates that with the exception of Germany, all of our sample countries have seen growth rates further worsen since the economic crisis. These poor prospects for investment and profitability have been reflected in corporate accounts as growing cash reserves (Macmillan, Prakash, & Shoult, 2014). Given their relatively high rates of return and success rates, paired with additional corporate social responsibility benefits to the corporation’s reputation, SIBs gain in attractiveness under these conditions. This is particularly true given historically low interest rates and returns on safe assets, as illustrated in Figure 18 by

declining yields on long term government bonds depicted, to the detriment of the wealthy and institutional investors seeking low risk investments.<sup>21</sup>

Table 15			
<i>Average Annual GDP Growth Rates</i>			
<u>Country</u>	<u>1961-1979</u>	<u>1980-2009</u>	<u>2010-2017</u>
France	4.6	1.9	1.2
Germany	3.8	1.7	2.1
UK	2.9	2.2	2.0
USA	4.0	2.7	2.2

Note: Data from OECD (2018).

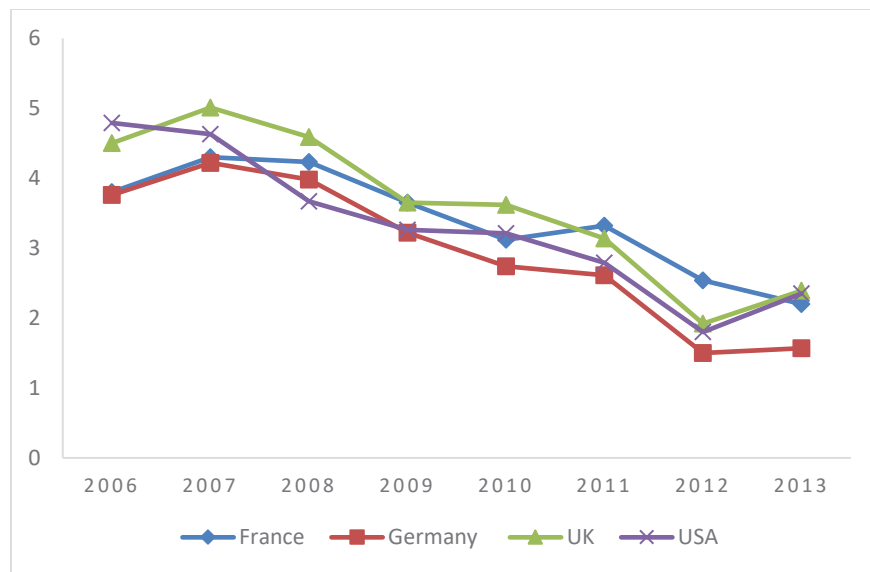


Figure 18. Long-term interest rate based on 10-year government bond yields, 2006 to 2013. Data from OECD (2018).

A final contextual factor in the post crisis era working in favor of SIBs is the fiscal pressures on the state generated from the crisis and the slow recovery. Figure 19 illustrates the magnitude of the

<sup>21</sup> Antolin, Schich & Yermo (2011) highlight the negative implications of low interest rates on defined benefit pensions funds and life insurers, and how an extended period of low rates may encourage increasingly risky portfolio management in attempts to increase returns. We suggest an equally plausible response would be to seek out new publicly subsidized investment opportunities such as SIBs and public private partnerships. Krugman (2014) highlights how it is the wealthiest who are effective hurt by low interest rates.

fiscal impact, which materialized more intensively in the early adopters of SIBs. As noted in Section II, SIBs are particularly well-aligned for a context of austerity. SIBs have been deemed contingent liabilities that are not required to be accounted for until the payment is due (Social Finance, 2011, pp. 23-24, 34-36), allowing government to increase social expenditure without immediately increasing deficits, and fit clearly into the ‘value for money’ narrative central to austerity-focused governance messaging. The opportunity for SIBs to ‘pay for themselves’ through savings becomes particularly attractive in this framework (Fraser, Tan, Lagarde & Mays, 2018, p. 10). It should be emphasized however that the scale of SIB development at this time is far too small to have a meaningful impact on any aggregate measures of debt or deficit, unlike their public-private partnership counterparts in infrastructure, for example.

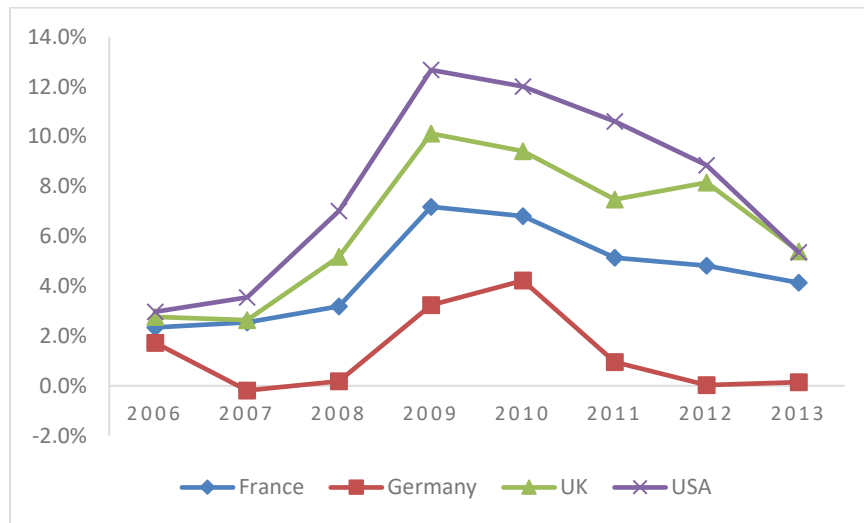


Figure 19. Government deficits as a percentage of GDP. Data from OECD (2018).

## V. The UK Versus the US

To recap, we have reviewed a number of indicators that collectively align the initial adopters and current leaders in SIB implementation, the UK and the US, as clearly distinct from two sample counterparts, France and Germany, two countries that have had minimal engagement with SIBs.

Across all of these indicators, the early adopters have more fully embraced neoliberal reforms. Based on every measure, it is the United States that is clearly the most neoliberal state amongst the four countries, but SIBs were founded in the UK. Why did SIBs not then arise first in the US? While a well-grounded evidentiary explanation would require a more rigorous ethnographic study of the policy making context of the respective national governments that eventually initiated SIB development, we sketch a suggestive path here. This contextual rationale is based on the recognition that for new policy instruments to be implemented, a number of factors must align (Kingdon, 2011): a problem must be articulated and recognized; a ready and feasible solution must be available and be conceptually well-developed; and these must fit with the government priorities and agenda of the day. The governance culture and institutional specificities of each country then can mediate the specific shape and timing of how broader structural changes materialize in different institutional contexts.

First, the antecedents of SIB emergence in the UK can be traced back to at least the early 2000s, and these were the product of the respective political-economic contexts and governance approaches of the national government of the day, both quite distinct from that of the US. While the Blair and Bush administrations were both pursuing domestic neoliberal reforms, the shape of these reforms were quite different. Bush's neoliberal policies were more conventional, including, for example, tax cuts for the wealthy and an extensive contracting out of military operations. Blair's Third Way neoliberalism, given his political vehicle, necessitated commitment to social justice in some form, and the form this took laid the groundwork and nurtured the policy infrastructure that would lead to the SIB model. Consistent with neoliberalism more broadly, there was a shift from traditional social democratic collectivism to othering of the disadvantaged, an emphasis on personal responsibility and self-betterment for welfare recipients, and dismissal of the state's ability to address these issues directly; This was contrasted with the dynamic potential of local and private social economy organizations to deliver poverty reduction programming, and the power of skills training and other

localized interventions as the solution to social exclusion (Amin, Cameron & Hudson, 2002, pp. 22-28). The massive expansion of the Private Finance Initiative for public infrastructure projects and related privatization measures (Whitfield, 2001 & 2007), emphasis on governance by performance indicators and measurement (Bevan & Hood, 2006), and the widespread implementation of pay by results in healthcare and labor market programming (Audit Commission, 2008; Finn, 2009), all also contributed to a foundational expertise and mindset that led naturally to SIBs. An emphasis by the New Labour executive on new public administration governance systems to manage, measure and deliver on political commitments (Barber, 2007) likely facilitated the saturation of these ideas into the public service.

Arising from this, the first UK SIB project was eventually developed as a result of a 2007 call from the Labor government for ideas to promote public-private partnerships to addressing social issues (Eames, et al., 2012, p. 7) and was subsequently advanced by the Labour government's Council on Social Action (Whitfield, 2015, p. 7). The entity that managed the first SIB project and subsequently went on to be the leading proponent of SIBs both in the UK and globally, Social Finance, was also the product of another New Labor social economy initiative.<sup>22</sup> Before the Labour government was defeated, the incoming Cameron government was already positioned with its "big society" vision, based on displacing "big government" through the localization of government service provision and a greater reliance on community, volunteer and non-profit organizations (Cohen, 2013; Coote, 2011, pp. 1-2). The new government then had a central campaign plank that provided a framework for the continued development and expansion of the SIB model, with the new conservative government becoming a reliable champion of SIBs over time, with David Cameron even using his presidency of the 2013 G8 meetings to add social investment, including SIBs, to the agenda (Cabinet Office, 2013).

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<sup>22</sup> Social Finance was initially focused on the establishment of a social investment fund seeded with the deposits in dormant bank accounts, with several founding members having served on the government's Commission on Unclaimed Assets, including the chair Sir Richard Cohen (Warrell, 2008). These efforts eventually led to the launch of Big Society Capital, fulfilling an election commitment of the Cameron government, as part of the Big Society vision. Big Society Capital has since become a major investor in SIB projects.

With the election of Obama, the US executive was faced with satisfying a similar political stakeholder group as New Labour, marking the start of an administration that would be naturally more inclined to SIBs, particularly given the Democratic Party's affinity with the financial sector. While the election was in the midst of the economic crisis, focussing the platform on the significant associated challenges, it did not take long for the administration to embrace the SIB concept, known as *Pay for Success* in the US. In 2009 the administration established the Office for Social Innovation and Civic Participation (OSICP), with a mandate to seek a more effective allocation of social service funding and support a focus on outcomes. In 2011, OSICP organized a national conference titled "Pay for Success: Investing in What Works" (Lake, 2015, p. 77) and went on to become a leading voice and funder of SIB projects in the US. Therefore, while the institutional and historical specificities of the respective countries may have led to the rise of SIBs in the UK, we suggest the structural features of US political economy are even more promising in the long run.<sup>23</sup>

## VI. Conclusion

Modern mainstream economic methodology gravitates towards ahistorical efficiency-based explanations of institutional constellations, while heterodox economists working in the critical political economy tradition emphasize power relations, the divergent interests of competing classes and the emerging and evolving political-economic social structure over time. In response to presented evidence and the case made by critics of SIBs that efficiency-based explanations are unconvincing, this chapter outlines an alternative explanation of the emergence of SIBs based on the congruence of the model with neoliberal governance and financialization. We have shown that the leading countries in SIB implementation have economic and institutional features most consistent with neoliberal governance practices and discuss briefly how each of these structural characteristics

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<sup>23</sup> A similar case could be made for public private partnerships in infrastructure, which also saw significant growth under Obama and was supported by federal policy interventions (Deye, 2015).



supports the establishment and proliferation of SIBs. This suggests that it is contextual alignment with the dominant political economic interests and ideology that is accounting for SIB emergence rather than their effectiveness or efficiency in delivering social programs. It also suggests that the timing of SIB emergence was not random. The context in the aftermath of a crisis clearly the product of neoliberalism and financialization, namely one of finance and the state facing a legitimation crisis, the growing fiscal crisis of government, and social-economic inequality becoming an increasingly salient topic of popular discourse, contribute to understanding SIB emergence at this juncture.

Our analysis is perhaps vulnerable to the criticism of over simplification, with our classification scheme and portrayal of France and Germany as neoliberal resisters, as both countries have also exhibited neoliberal tendencies. German Finance Minister Wolfgang Schaeuble's notoriety over his eight-year tenure for advocacy and imposition of EU austerity pressures in the aftermath of the financial crisis;<sup>24</sup> the recent election of investment banker-turned-president Emmanuel Macron on a platform of tax cuts for the wealthy, reductions in the civil service, and entitlement cuts; and the signature labor market reforms facilitating layoffs and reductions in working hours by employers of his Socialist predecessor Hollande; all these examples raise questions in this regard. Given the global nature and integration of the capitalist system, a dissemination of governance trends is to be expected. At a fundamental level however, the data is clear: there are demonstrable structural differences between the two sets of countries that indicate that the effect of neoliberal reforms have been far more extensive in the US and the UK.

This work contributes to the foundation of a political-economic approach complementing the relative cost critique of SIBs, highlighting the challenges faced by the model in overcoming its high administrative and transactions costs, the need to pay out financial profits above the government cost of borrowing, and the potentially detrimental behavioral impact of introducing the profit motive into a public social service delivery context, but further ethnographic research or case studies is

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<sup>24</sup> See Mason (2018) for some candid descriptions courtesy of Yanis Varoufakis.

warranted to test the chain of causality in practice. While we believe the benefit to for-profit private stakeholders is clear, these case studies would be valuable in specifying the role of private for-profit stakeholders in the development and adoption of SIBs, in addition to a broader understanding of the roots of their emergence. Weaver (2015) for example, in his analysis of the neoliberalization of urban policy through the institution of enterprise zones in the UK and the US provide a model for such studies.<sup>25</sup>

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<sup>25</sup> Interestingly in Weaver's case studies, the specific tools being pushed were not initially supported or driven by the private interests that ultimately directly benefited from them, necessitating a focus in his work on how and why neoliberal policy ideas are driven forward under such circumstances. In the case of SIBs however, initial evidence suggests that the key initial proponents and current advocacy organizations have clear and direct ties to the financial industry that stand to benefit from the SIB model.

# Chapter 8: POLICY RECOMMENDATIONS, REFORMS, AND ALTERNATIVES

## Introduction

This chapter concludes our dissertation examining SIBs as a new model for delivering social public programs. Our goal was to explain and describe the development and theoretical motivations of SIBs, to provide a solid foundation for future study of how effective they have been in practice in the short period of their existence. In this final chapter, we begin by reviewing our policy recommendations for structuring SIB projects going forward that we believe will help the SIB model, if selected, better realize some of its claimed potential. In the following two sections we then take a step back and briefly examine the implications and potential of the SIB model in contrast to a more traditional social democratic approach to poverty reduction and social inclusion. Section II looks at how SIBs continue the neoliberal trend away from universalism to targeting of social benefits, with negative implications for meaningful and wide-spread progress on social exclusion and inequality. Here framing effects of SIBs are reviewed, demonstrating how a focus on individualized responses, from a macro-perspective, has the potential to marginalize large-scale collective approaches and societal changes that address systematic inequity and recognize that poverty, disadvantage and inequality are structural features of capitalism that if left unchecked will continue to grow in breadth and intensity. Section III presents what we call the micro alternative to SIBs, a reinvestment in the capacities of the state to be an entrepreneurial leader in generating social programs that better meet the needs of the disadvantaged and society more generally.

## I. Recap of Policy Recommendations

The main finding of our analysis up until this point is that the proponents' case for SIBs, while rhetorically strong, faces some fundamental weaknesses when systematically examined. SIBs have built in incremental costs relative to conventional publicly funded service delivery, and struggle to make the case that they can generate efficiencies sufficient to overcome these costs. At best, as currently structured, SIBs may have a claim to betterment relative to a hypothetical, dysfunctional status quo. But even in this case, the government leadership and structural reforms required to make SIBs happen suggest that this effort could be better spent on more straightforward improvements, without the added complexity and risks entailed in the impact bond model. Overall, as currently operating, SIBs appear to be a pricy experiment in a context of restraint, that is not generating much, if any, innovation.

Despite our generally pessimistic central message above, SIBs have been successful in focussing attention and interest on evidence-based social program investment. This a welcome contrast to the inattention and regressive attitudes typical of the early neoliberal era. There is wide variation in how SIBs are being structured and we believe these details are important in determining whether SIBs can be part of a constructive set of solutions to growing inequality and social exclusion going forward, or an exacerbation of neoliberal reforms to social service delivery that only reinforce deterioration in this regard.

### a) Procurement Model Selection and Appropriate Counterfactual

Following the UK Auditor General's (Morse, 2015, pp. 6-8, 33) recommendations on PbR more broadly, we suggest that all SIB projects would benefit from an explicit assessment of the model in the targeted program or policy area relative to conventional procurement or public delivery, and that

how value for money in these comparisons is measured be stated explicitly. Auditors General could implement and coordinate standardized reporting practices between departments and governments. These frameworks should account for the resources required within and outside government to develop and operate the SIB infrastructure needed to administer the project, track and evaluate outcomes, and improve project management capacity.

On a related but distinct note, many SIBs rely on the use of existing publicly-funded services or limited private sector opportunities without clearly accounting for the fact that utilization of these resources likely precludes their utilization by others. For example, some child welfare family preservation, homeless amelioration and anti-recidivism SIBs rely on placing clients in existing social housing supports. Others rely on making use of existing apprenticeship and public health services. When generating the counterfactual for the evaluation of outcomes, the use of these existing services should be accounted for, specifically whether it is access to the underlying public service or in the incremental supports generating the outcomes, and if the SIB client's utilization of the service displaces another potential client. Given the preferential status being given to SIB programming and its investors, more focus should be placed on this attribution.

Given that SIBs face higher transaction and administrative expenses, governments should be explicit in identifying the full cost and how the SIB model itself will generate the targeted outcomes more efficiently than alternative models. The appropriate counterfactual here would not be the status quo but an equally resourced conventional model. One of the noted advantages of SIBs is that they help reverse under resourcing of capacity building in the areas of management and evaluation in service delivery organizations, with resources for these activities built into the model (Liebman & Feller, 2014). A useful counterfactual for future research would be to fund conventional providers directly with an equivalent in incremental resources for enhanced project management and administration to those that are made available through the SIB model to pay out investor returns and higher transaction costs (Whitfield, 2015, p. 34).

## b) Outcome Target Selection

A fundamental problem with pay by results compensation for the delivery of social services is that objectives are multifaceted and challenging to measure, necessitating reliance on incomplete outcome measures. High powered incentive-based payment can distort service provider behavior in this context and compromise overall service quality by incentivizing the redirecting of efforts from hard to measure, poorly monitored outcomes, to ones that are easily measured. Funding reforms based on payment by outcomes also can be interpreted as questioning the abilities and integrity of service providers and may lead to the displacement of intrinsically motivated efforts and commitments to service quality. To improve the likelihood that SIBs lead to improvements as opposed to declines in service quality, we recommend that governments work with non-profit funders and service providers, including front-line staff, to collaboratively set targets with investors and the intermediary to build program metrics deemed reflective of client well-being, not just government savings. This in all likelihood would see indicators diverge from those tied directly to cashable fiscal savings for government and result in more elaborate compensation outcomes structures, but these would likely reduce the risk faced by investors and thereby reduce the required rates or return that would be otherwise required to secure investment. This participatory methodology should be applied to the broader program structure in addition to metrics, with the opportunity to adapt and innovate in response to program developments.

## c) Investor Selection Process, Rates of Return, and Proactive Disclosure

As part of the broader procurement selection process and to reduce the potential for excessive or inappropriately high rates of return and displacement of intrinsic and/or philanthropic efforts, we recommend SIBs institute a transparent investor selection process that evaluates and justifies the value-added of investors to the project based on the nature of the organization providing funds and

specifies any restrictions around the use of outcome payments. Based on our analysis, SIBs can only provide meaningful improvements in social program efficiency if financiers provide value-added over and above the costs they add to the project. If investors are being compensated above government borrowing rates, they should be required to generate efficiencies through project management and selection improvements that more than offset the differential between the expected rate of return and government borrowing rates, if they are to provide value for money.

Given that the construction of such an estimate may be challenging, some simple rules that could be implemented to act as safeguards include restricting rates of return to or below the cost of government borrowing. This will help provide reassurance that government is not transferring rents in the form of interest payments to the private sector investors and is attracting investors motivated primarily by CSR concerns. It would also reassure NPO stakeholders that SIBs are not diverting funds from social service delivery. Alternatively, governments could limit investors to non-profit investors with well-regarded reputations for social and fiduciary responsibility based on a track record of supporting high performing social service delivery, or require investors to explicitly commit that any returns be reinvested in social service projects. The latter could require the establishment of an independent NPO to receive and reallocate outcomes payments.

Some SIB proponent narratives often implicitly suggest that private for-profit investors should be adequately compensated for risk and should receive a market rate of return on their investments in SIBs. We see no justification for this logic given the philanthropic attributes and corporate social responsibility benefits associated with financial involvement in these projects.

We also recommend a standardized and transparent process for proactive public disclosure around SIB project outcomes, specifically including returns paid to investors. This would assist in determining whether public funds being paid out as outcomes payments are providing value-for-money relative to more conventional social service models, and whether the interest rates being paid out to investors, apparently well above the cost of conventional public borrowing, are justified.

#### d) Pursuing 'Common Sense' Improvements Independent of SIBs

The most promising attributes of the SIB model, in our opinion, are (1) the built-in central coordination within government to break down siloed decision-making between departments to determine the net impact of a social service intervention, and in turn funding initiatives that are expected to produce a social return and potentially a financial return to government; and (2) the related incremental resources for research, evaluation and performance management within service delivery agencies. According to the data reviewed in Chapter 1, the potential gains from this approach appear substantial, and example structures such as the Washington State Institute for Public Policy provide a template for a systematic approach to inform this type of process. This could be pursued independently of SIB development, realizing the core value of what is central to the SIB model and the underlying source of returns paid to investors. This forms the basis of our 'micro-alternative' explored below.

## II. The Micro Alternative: Conventional delivery through (re)building state capacity

Despite the potential for more positive variants, more generally we are pessimistic of the ability of SIBs to generate meaningful progress on reducing inequality and social exclusion. SIBs fit clearly into a logic of neoliberalism and financialization that has resulted in a reformulation of the state and reduced capacity to effectively intervene in supportive social and economic intervention to support equitable development. Public sector reforms based on neoliberal ideas and new public management have systematically reduced this capacity, through contracting out, privatization, and the shift away from the view of government of a provider of service, to a procurer of service. This generated an increasing role for the private sector in the delivery of public services, particularly in the UK, US, and



other countries who are leading in SIB implementation. SIBs further the transference of responsibility and activity from the public to private sector. In this section we suggest that the fundamental social problems motivating SIBs arise from precisely these trends, and that in fact the reverse is what is required.

The non-profit sector has both advantages and limitations when it comes to delivering public services. Its targeted specificity, flexibility and adaptiveness, and ability to leverage voluntary contributions can lead to innovative, locally adapted service provision. While acknowledging these advantages, the weaknesses of the non-profit and charitable sectors have also been emphasized, with the emergence of the modern welfare state as a response to inherent limitations of the non-profit sector (Salamon, 1987, pp. 38-42). These limitations include resource constraints, small scale operations of limited scope, the sectors' uncoordinated and overlapping nature, and the lack of accountability and professionalization. The nature of civil service employment and capacities in many respects offers a solution to these challenges: a high degree of professionalization with the associated job ladders, career longevity and accumulation of institutionalized knowledge and expertise; built-in formal structures of knowledge exchange through inter-jurisdictional associations; and a capacity to engage meaningfully with academics and other researchers.

There is much to be said for the unique position and ability of government to engage in constructive intervention in the economy to directly address the social issues (Chang, 2003, pp. 51-63; Musgrave, 1999, pp. 34-36), such as those being targeted by SIBs, but there is evidence that this capacity, particularly in liberal advanced economies, i.e. those leading SIB development, has been systematically eroded. For example, Light (2016), in his examination of the US federal government, reviews the increasing number of "government breakdowns", highlights how "government was not always so vulnerable" (p.1). He highlights the shift from the effective governance of the postwar era and the subsequent "disinvestment in government's capacity" (p. 5) by the US congress over time. This has led to previous successes in policy and program areas including anti-discrimination, voting

rights, public health, and access to social services, being increasingly and intentionally undermined and put at risk. He concludes that most of the breakdowns identified “were the predictable consequence of decisions made by Congress and the president” some of which were “carefully designed through backdoor budget cuts, hiring freezes, sequesters, duplication and overlap, and a host of administrative ills” (p. 18).

Rhodes (1994) points to a similar disinvestment strategy in the UK which he terms the “hollowing out” of the UK state through civil service reductions, privatizations, contracting out, increased “managerial control reduc[ing] civil service discretion” (p. 145) and “fragmentation” (p. 147) that damaged both the administrative capacity and effectiveness of the civil service. Pyper (2011), while recapping the negative consequences of such hollowing out, points to the emergence of a new generation of privatized management and policy consultants, often partisan in nature (see also O’Toole, 2006). Conservative reforms saw reductions in the civil service, excluding privatization of crown corporations, of almost 30% between 1988 and 1994 (Clayton & Pontusson, 1998, p. 82), while recent austerity measures have generated a new wave of reduction, with the civil service numbers falling by 19% between 2010 and 2017 (Freeguard, Adam, Andrews & Boon, 2017). Toynbee & Walker (2017), based on their interviews with a variety of public servants, speak of a “dismembered” government, where the “social state... [is] threadbare, ... and other functions are dilapidated” (p. 9). Even within social democratic states, public sector employment reductions were significant. Sweden for example saw staff reductions in the early 1990s in the range of 12%, with reductions in health-related occupations falling by 7%, care services for the vulnerable by 10%, and in education 4%, while large overall reductions were also seen in Australia, Belgium, Finland, and the Netherlands, in the range of 2.5 to 9.9 percent (Clayton & Pontusson, 1998).

By contracting out the strategic coordination, vision setting and management, SIBs contract out the functions which theoretically governments have a comparative advantage in delivering, furthering this diminished capacity. There has been a growing acknowledgement of the need for

government to take leadership and build capacity in strategic planning, with emphasis on developing the capacity to undertake structural change within governments to support the civil service in more effectively delivering on commitment (see: Barber, 2007 & 2014). These capabilities rely on traditional planning and Weberian bureaucratic benefits that have advantage over market-based processes, an approach that will be required if the high levels of economic inequalities generated by neoliberalism are to be reversed. While the non-profit sector has increased its capacity throughout this era and has some advantages, in an age of austerity it is equally under pressure and continues to lack resources necessary to compensate for state retrenchment. An emphasis on a further hollowing out through instruments such as SIBs comes at a cost. We suggest efforts should focus on rebuilding the capacity of government to act as a strategic planner, coordinator and active agent of social service delivery.

### III. The Macro Alternative: Universalism vs. Individualized Approaches

In addition to the undermining of state bureaucratic capacity, neoliberal retrenchment also resulted in an undermining of state provision of universal social programs and benefits and the scaling back of social insurance and assistance systems. Here we propose that: this is also a driving factor in the growing social challenges SIBs aim to address; that rebuilding these programs is a more sensible approach to making progress on combatting these trends; and that SIBs are not aligned with this approach.

Over the 20<sup>th</sup> century, significant welfare states were built up in many of the advanced western market economies. Universal health, education, pension, family benefits and other social programs and collectivist solutions were developed and expanded in the post war era, in a clear response to political pressure of workers' movements and the failures of capitalism to generate shared prosperity and development. Although there is significant variation in extent, this general trend towards development of universal social programs was present in both more liberal countries such as Canada

and the United Kingdom, and the more paradigmatic social democratic Nordic countries including Sweden and Denmark (Béland, Blomqvist, Goul Andersen, Palme & Waddan, 2014).

In the UK, for example, while early 20<sup>th</sup> century social welfare programming saw incremental growth through the launch and development of contribution-based social insurance programs for workers and the unemployed, World War II and the subsequent Beveridge report ushered in a leap to universalism. In the immediate postwar period legislative initiatives were launched that generated a number of universal social programs that were available at no cost or without eligibility exclusions, including public healthcare through the National Health Service, access to primary and secondary education, and a cash family benefit (Barr, 2004, pp. 30-32). Building on previous systems, a more robust and compulsory social insurance system, paid for by joint employer-employee contributions, was also instituted to provide income support benefits in cases such as unemployment, maternity leave, illness and retirement. The social insurance system, initially funded by a flat rate contribution, was later based on earnings and became redistributive both in its financing and distribution. A parallel system for means tested benefits was also developed for those not sufficiently supported through the social insurance system. All of these programs saw growth and maturation over the three decades after the war (Barr, 2004, pp. 33-35).

Even in the United States, where commitment to state provision and universalism has been historically weak, public social program expansion during the post war era was significant, with the implementation of Medicare/Medicaid, social security, and expanded access to post-secondary education through measures such as the GI Bill and growing state public education systems. There were significant enhancements in the post war period to the Social Security system's insurance-based benefits, launched in the 1930s, "to the point where, together with related programs, virtually all workers and their families were covered" (Barr, 2004, p. 35), with benefit levels also becoming more generous and progressive. Although means-tested assistance programs under Social Security did not embrace universalism or expand to the degree they did in the UK, some expansion did occur, such as

allowing for payments under the Aid to Dependent Children program (ADCP) where the father was unemployed, as opposed to absent or disabled.<sup>26</sup> In both the UK and the US then, there was a movement over the 20<sup>th</sup> century period away from a stigmatization of benefit recipients and need to demonstrate impoverishment to get access to support. Fundamentally underlying these social benefit programs during this period was a commitment to full employment as “the primary method of income support” (Barr, 2004, p. 37), a measure included in broader definitions of the welfare state (Esping-Andersen, 1990). This commitment to full employment, along with the associated high rates of labor force participation it can generate, leads to the potential to establish a quasi-universalist system of social benefits while having many programs still tied to employment, such as was the case in Sweden in the 1970s and 1980s (Clayton & Pontusson, 1998, p. 77).

The above commitment to universalism was considered by some as a positive development for social equality and sustainability. As recapped by Sen (1992), targeting in social programs has many shortcomings, including exclusion of the eligible due to informational challenges, encouraging perverse and unproductive behavior to qualify, increased administrative costs, postponements in accessing service, intrusiveness and stigmatization of the poor.<sup>27</sup> Also as noted by Sen, the political economy of social programs leads to a systematic trend of defunding, low quality and insufficiency with targeted programming, while universal programming, due to broad-based consumption and the social solidarity generated as a result, is more politically sustainable, effective and robust. While neoliberal proponents rely on the case that targeting will lead to greater benefits to those who need it the most, others have argued that the opposite is true once the political factors around government budgetary allocation are considered (see also: Gelbach & Pritchett, 2002; Kidd, 2015). This *paradox of redistribution*, that universalism will lead to greater redistribution relative to targeted programs,

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<sup>26</sup> For further discussion of history of UK welfare state, and to lesser extent history of the US welfare state, see Barr (2004, pp. 16-41).

<sup>27</sup> Sen suggests that some targeting is inevitable in all social provision due to decisions as to where to offer service and the determination of what particular social service is offered. He suggests that “capability-orientated” (p. 19) targets, rather than income targeted programs, are better at avoiding abuse, such as benefits based on disability and health status, for example. He notes that certain social services have strong self-selection attributes that mitigate abuse such that those using the service must consume it directly and generally only do so if needed and well suited to receive service, such as healthcare, literacy and employment-of-last-resort programs.

due to greater political support and larger budgets for social programs, while challenged over time, continues to be empirically supported (Korpi & Palme, 1998; Jacques & Noël, 2018).

Since the late 1970s increasing universalism through collectivist approaches has, for the most part, been halted and has been put on the defensive in many countries (Gilbert, 2017; van Orschot, 2002). Increased means-testing and the introduction of parallel private provision accessed primarily by the wealthy has created parallel private systems in some cases, with universalism in retrenchment in some policy areas (Béland et al., 2014). This, combined with the abandonment of full employment commitments, increasingly hostile environments for unions, and other neoliberal policy reforms has led to growing income inequality and precariousness of work. While the welfare state framework and program eligibility endured in some respects and policy areas in the face of ambitious regressive attempts at reform (Pierson, 1994 & 1996), the changing nature of work amplified the impact of successful scale-backs (Clayton & Pontusson, 1998; Korpi & Palme, 2003; Starke, 2006). This has materialized as significant reductions in benefit levels in many countries, for example the income replacement rates provided by social insurance in cases of unemployment or sickness (Pintelon, 2012), despite social public expenditures trending upward over time.

In the UK, the reforms initiated by the Thatcher government resulted in significant restrictions in eligibility and reduction in value of unemployment benefits, a retrenchment of social housing support, and reductions in the value of child benefits (Clayton & Pontusson, 1998). More recently in the UK under the conservative government, McKee and Stuckler (2011) describe a “progressive exclusion of the middle classes from the welfare state, through incremental erosion of universal benefits” (p. 2) in areas such as child benefits and post-secondary education.

In the US, early in his tenure, President Reagan instituted significant cuts to unemployment benefits and the Aid to Dependent Children program.<sup>28</sup> The 1990s, under the Clinton administration,

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<sup>28</sup> There were some partially offsetting benefit increases later during Reagan’s presidency through food stamps and the introduction of an earned income tax credit (Pierson, 1996, pp. 164-165), although these were limited and the latter only provided assistance to those with some employment earnings.

saw significant reductions and eligibility restrictions to the food stamp program, and a similarly aimed overhaul of the Aid to Dependent Children program with the introduction of funding caps, work requirements, and limits on years of eligibility (Clayton & Pontusson, 1998). Countries with relatively larger welfare states saw similar reforms, with aggressive reduction in unemployment and social assistance benefits, while more tempered reductions in pension benefits. Sweden, the exemplar of social democracy, saw a similar trend but with retrenchment more widely spread amongst the population, given the more universal nature of the country's social programs, with the introduction of waiting periods for unemployment benefits, user fees in healthcare, and a downloading of sick leave benefits to employers (Clayton & Pontusson, 1998). This was reflective of a broader trend of recommodification in the Nordic (and western Anglo-Saxon countries), while continental Europe remained relatively stable with respect to welfare state benefits, at least with respect to social insurance programs (Pintelon, 2012). In general then, there were sustained restructuring trends with a movement away from universalism to social insurance, and a move from social insurance to means testing (Clayton & Pontusson, 1998, pp. 90-91).

Support for the disadvantaged has then become increasingly targeted and individualized. In addition, both economists and governments have increasingly focused on 'human capital' and individualized approaches that aim to 'fix' people, framing poverty and disadvantage as individual failings as opposed to natural systematic outcomes of capitalist economies. A key example of this is in the areas of income support benefits and an increasing emphasis on labor market activation, i.e. moving unemployed workers into jobs through individual level programming and work-seeking obligations (Bonvin, 2008; van Berkel, 2009). In economics, particularly in the field of international development, there has been a turn to randomized control trials (RCTs) and the application of 'nudge' interventions aimed at tweaking or influencing individual behavior amongst the poor to support them in making better decisions regarding time allocation, investment in education, etc. The underlying assumption of this approach, exemplified by the work of Banerjee and Duflo (2007, 2011),

is that while market failures such as a lack of access to credit or information play a role, the poor exhibit significant discretion with respect to how they allocate their resources, and apparently make bad choices that lead to a continuation of impoverishment. The assumption is that small changes can lead to big differences “without changing the existing social and political structure” (Banerjee & Duflo, 2011, p. 271).

This focus on these small changes in individual behavior at the expense of broader discussion regarding appropriate policy regimes and economic structures has been identified as problematic by Reddy (2012) from at least two perspectives. First, the macro-institutional context, including the political, historical and economic, acts as a mediating and intervening force on micro interventions. This leads to impact varying between contexts, bringing into questions the validity of the approach and the presumption that scaling up the intervention will generate similar results in different jurisdictions. Secondly, and also emphasized by Chernomas and Hudson (2017, pp. 33-36), this approach sidelines structural reforms to economic and social policies and institutions, and the associated “impact of political dynamics and processes of social change” (Reddy, 2012, p. 62). As Reddy (2012) notes it is in fact this political and socio-economic context that generates the “causal relations” (p. 65) being tested to begin with.

Part of the shift towards targeted interventionism as opposed to universalism has been linked to the shifting political alliances that have more generally sustained support for the welfare state and social democracy, albeit in its third-way form. Gingrich and Häusermann (2015) for example highlight the “pro-welfare” political coalition that emerged with the shift from industrial to post-industrial society reduced reliance on the “manual working class”(p.51), while drawing on new higher skilled/educated middle class “interpersonal service workers” (p.53), many whose employment have resulted from an expanded welfare state. The growing importance of cultural issues at the expense the economic also led to a partial shift of political support of the traditional low-skill working class. These shifts simultaneous led to a partial diffusion of support for the welfare



state amongst political parties, with conservatives weakening their opposition to social insurance schemes, while social democratic parties adapted to their new supporting coalition by shifting away from universalist income replacement programs towards targeted programs and a focus on “social investment”(p.51) in health, education and labor market activation. Gingrich and Häusermann (2015) however do highlight how these results are shaped by welfare regimes, and how welfare state stabilization has not been observed in liberal market economies.

SIBs continue this trend, leaving the origins of social ills unaddressed, “prioritizing individual-level measures over systemic ones” (Maier & Meyer, 2017, p. 4; see also Joy & Shields, 2018). This trend cuts across policy intervention areas, with resources often being provided to connect participants with existing socially provided or subsidized programs and services, including housing, apprenticeship and work placements, and health services. SIB projects are adding incremental capacity to connect a small number of individuals to these services as well as new coaching and psycho-social interventions such as cognitive behavioral therapy, to cope with and help manage the damage stemming from social disadvantage. Overall however, the lack of universal access to these foundational social services and opportunities remains unaddressed.

More fundamentally, as highlighted by Whitfield (2015), the root challenges, including “lack of jobs, low income, financial exploitation, overcrowded and poor living conditions, crime and violence, environmental hazards and ill health” (p. 4) are not being addressed (see also: Dowling, 2017, p. 305; Joy & Shields, 2018). He points to, for example, the preponderance of workforce development SIBs focusing on supply side training and job placement measures that do not create incremental jobs. Neither do these address systematic discrimination in labor markets. A similar critique could be levied against anti-recidivism SIBs, many of which are based on employment related supports. Parallels exist in all other service areas targeted by SIBs: Child welfare SIBs are not addressing the poverty, discrimination and lack of or precarious employment faced by at-risk families that lead to family instability; health SIBs do not address the social determinants of health and underlying

environmental factors that lead to illness to begin with; and environmental SIB projects producing flood mitigation infrastructure in response to impacts linked to climate change, which remains unaffected. While prevention is built into the language and mantra of SIBs, it is more often a diversionary approach for the small selected population, leaving the broader social hazards unaddressed, left to impinge on other victims. In sum, SIBs reinforce an individualized approach and continue the stigmatization that has been part of the neoliberal trends, undermining collectivist approaches such as universalism and broader commitments to full employment that help address the underlying sources of disadvantage.

The current socioeconomic instability and emergence of nationalist and populist movements based on insider-outsider politics has been linked by several heterodox economists to the evolution of neoliberalism and the associated growing insecurity and precariousness of a large portion of the working class, the dismantling of social safety nets, expired commitments to full employment, and unseated normalcy of reliable full-time employment (Duroy, 2014; Kotz, 2017a; Standing, 2012). Growing economic inequality and prejudice can be self-reinforcing, however, counter measures can equally generate synergies (Haight, 2013). Reconstruction and renewal of a universalist welfare state approach, based on historical evidence, is more aligned to addressing the underlying root causes of growing inequality, precariousness and social exclusion. The scale and urgency of addressing the growing inequality rooted in neoliberalism cannot reasonably rest on targeted residual social programs that feed the divisive othering and individualization of poverty and disadvantage. The contradictions inherent in SIBs suggest that it will not be possible to reach the scale required in this context or generate the structural institutional shifts required for meaningful and sustainable change. Rebuilding the broader welfare state based on notions of collectivism, and the institutional supports required to implement and sustain such structural change is likely a more advisable approach to meaningfully address these challenges.

## IV. Conclusion

Our analysis challenges the broader assumptions behind the SIB model and what solutions are required. SIB proponents put forward that the socioeconomic challenges with which we are currently confronted require 'all hands on deck', that the resources, diversity, innovation and financing of the private sector are required to best address the growing socio-economic challenges with which we are faced. There is some rationale in this claim. Targeted social service support is necessary for those who are acutely disadvantaged and require targeted, personalized support to overcome the multifaceted and integrated barriers associated with long-term impoverishment. SIBs, when reformed within the parameters we suggest, may have a limited role in helping support the diffusion of targeted best practices in areas that currently attract significant philanthropic support, with governments playing a role in helping leverage and coordinate this investment more efficiently.

However, SIBs, as portrayed by proponents, mis-frame what the private sector more broadly, and SIBs specifically, are capable of and well-placed to deliver, and the broader socioeconomic challenges society faces. SIBs divest governments of coordination, planning and dissemination responsibilities in social service delivery, that they are structurally well-positioned to deliver. SIBs face inherent costs that need to be overcome and have a weak a priori foundation for claims that they will generate sufficient improvements to overcome these disadvantages. In practice, even when viewed as a second best and expensive solution to overcoming government funding and capacity constraints, the case for SIBs is underwhelming. In the current context of austerity, SIBs as currently structured, with their apparently generous investor compensation rates, are more likely a drain on limited government allocations as opposed to generating incremental resources for social services. SIBs also do not appear to be generating innovations, but replicating existing models founded on prior public and philanthropic investment. SIBs continue the neoliberal trends that have led to the massive increase in inequality being used to justify their necessity. Overcoming the challenges of growing inequality will require structural change based on a reinvestment in the civil service, rebuilding of labor

movements, and ultimately the rebuilding of a reimagined welfare state. While no doubt a monumental task, to quote governance guru Michael Barber (2014) somewhat out of context, “for a target to have real impact on the ground it has to be motivational, it has to have that moral purpose” (p. 24). Universal access to a high quality and well-funded set of public services available to all, we believe, provides such a calling.

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# Appendix A: Definitions of SIBs

This appendix provides in detail the sample definitions of the SIB model used to construct Table 1.

Dear et al. (2016), on behalf of Social Finance, arguably the leading proponent and intermediary participant in SIB projects in several countries, defines SIBs as follows:

[A] Social Impact Bond is a public-private partnership which funds effective social services through a performance-based contract. Social Impact Bonds enable federal, state, and local governments to partner with high-performing service providers by using private investment to develop, coordinate, or expand effective programs. If ... the program achieves predetermined outcomes and performance metrics, then the outcomes payor repays the original investment. However, if the program does not achieve its expected results, the payor does not pay for unmet metrics and outcomes (p. 12).

Deloitte (2012), the Canadian member firm of Deloitte Touche Tohmatsu Limited, which has acted as a formal evaluator of SIBs in Australia and the Netherlands (Gustafsson-Wright et al., 2015) describes SIBs in the following passage:

Social Impact bonds present an alternative investment model... [f]ocused on preventive action, ... a contract in which the government agrees to pay for improved social outcomes. Under this arrangement, the intermediary raises money from private investors... then turn to service delivery organizations to implement innovative solutions to social problems. If the solution achieves the agreed upon social outcomes, the government pays the investors, through the intermediary, a share of the spending that is saved as a result, based on the degree to which the social outcome is achieved.... The financial returns that investors receive depend on the degree to which the outcomes are achieved. (p. 3).

In a more recent publication, Deloitte and the MaRS Centre for Social Impact Investing, which offer SIB advisory services and is acting as the intermediary in a Canadian cardiovascular disease and stroke prevention health SIB (Farthing-Nichol & Jagelewski, 2016), use the following definition:

A Social Impact Bond (SIB) is based on a pay-for-performance contract in which the government agrees to pay for improved social outcomes. A partnership between investors, service delivery organizations, government and, potentially, an intermediary is established to tackle a specific social issue. If the solution achieves the agreed-upon social outcomes, the government pays the investors against a pre-agreed scale. As such, the risk of non-performance is transferred away from the government to the investors, whose financial return is based on the achievement of outcomes. (Cuifo & Jagelewski, 2014, p. 12)

The Young Foundation, a UK-based foundation focused on social investment finance and innovation, which partnered on the design of an anti-homelessness SIB with Social Finance (Aylott, 2012), uses the following definitions of SIBs:

Under an SIB, a payer (usually Government, at a national, regional or local level) agrees to pay for measurable improved outcomes of social projects, and this prospective income is used to attract the necessary funds from commercial, public or social investors to offset the costs of the activity that will achieve those better results. This approach is possible where better outcomes lead to tangible public financial savings. (p. 5)

SIBs are funding mechanisms which invest in social outcomes. They have three elements: Monetary investment ... from local authorities, commercial investors, philanthropists or foundations; A programme of actions to improve the prospects of a group...; and, Commitments by national or local Government, or foundations, to make payments linked to improved social outcomes achieved by the group (for example, re-payment of the £x million original investment and an extra percentage agreed return, sustained by reduced costs...). SIBs are generally likely to work best in situations where there are misaligned incentives to develop, fund and deliver preventative services that can save costs down the line and achieve a better result from the system as a whole. (Mulgan et al., 2011, p. 7)

Jeffrey Liebman, the Malcolm Wiener Professor of Public Policy at the John F. Kennedy School of Government and Director of the school's Government Performance Lab, an organization that provides pro bono technical assistance on SIB projects and outcomes based social service contracting (Liebman & Feller, 2014), in 2011 defined SIBs as follows:

Under the social impact bond model, a government contracts with a private sector financing intermediary ... to obtain social services. The government pays ... entirely or almost entirely based upon achieving performance targets. If the bond-issuing organization fails to achieve the targets, the government does not pay. In some cases, the government payments may be calculated as a function of government cost-savings attributable to the program's success.

The bond issuer obtains operating funds by issuing bonds to private investors who provide upfront capital in exchange for a share of the government payments that become available if the performance targets are met. The bond issuer uses these operating funds to contract with service providers to deliver the services necessary to meet the performance targets. (Liebman, 2011, p. 2)

Liebman later notes that SIBs in the United States will require "a neutral authority to measure outcomes and resolve disputes about whether performance targets were met, and bond-issuing organizations to raise private capital and manage service providers" (p. 15-16).

Gustafsson-Wright et al. (2015) who undertake a detailed study and inventory of SIBs, overseen by an advisory group of thirteen individuals and based on a consultation group of 115, describe SIBs in the following terms:

The Social Impact Bond... harnesses private capital for social services and encourages outcome achievement by making repayment contingent upon success.... [SIBs] combine some components of results- or performance-based financing and public-private partnerships.... However..., financing is provided upfront rather than when results are attained..., results in social impact bonds are usually related to outcomes as opposed to outputs..., [and SIBs] focus on the delivery of human services as opposed to the traditional physical infrastructure that has often been the center of both public-private partnerships and performance contracts.... [SIBs] bring in private sector rigor and performance management to drive results. (p. 2)

In this model, private investors put up capital to fund a social intervention and governments repay the investor only if an agreed-upon outcome is achieved. Development impact bond (DIB) is a term used for an SIB that is implemented in low- and middle-income countries where a donor agency or a foundation is the outcome funder as opposed to the government (although some combination of government with third party is also possible). (p. 4)

In the United States the terminology 'Pay For Success' (PFS) more specifically, pay for success financing (PFSF) is the terminology used to describe SIBs. President Obama's Office for Social Innovation and Civic Participation (2016) defined the concepts as follows:

PFS... tests and advances promising and proven interventions, while providing taxpayer (or other) dollars for successful outcomes for families, individuals, communities, or natural resources.... Through PFS, government (or another entity) enters into a contract to pay for concrete, measurable outcomes once they are achieved for specific people or communities in need.... payments are made only if the intervention actually achieves the outcomes agreed upon in advance.... [R]esources are not expended until the services have produced a specific benefit.... PFS contracts often incorporate PFS financing, which covers the costs of delivering an intervention until success is achieved and payments are triggered. Investors...take on the risk of failure. Where PFS financing is used, the government (or other entity) typically makes outcomes payments that cover the cost of services and also offer investors a modest return. PFS financing is sometimes referred to as social impact bonds.

PFS contracting and financing require partnership among multiple stakeholders. Partners typically include...outcome payors...; Service providers...; Investors (if PFS financing is part of the project)...; and, an independent evaluator. Many PFS projects also include a project coordinator or intermediary.

The Harvard Kennedy School's Government Performance Lab website (2017) has a similar definition and distinction between SIBs and PFS contracting:

Pay for Success contracting using social impact bonds combines two tools—a performance contract and an operating loan or social impact bond. Under the performance contract, the government purchases social services aimed at a specific target population. Instead of paying directly for the quantity of services delivered, the government pays based on the outcomes that are achieved by the services...These outcomes are measured by an independent evaluator....The government commits to pay for outcomes successfully achieved. If the intervention fails to achieve the minimum target, the government does not pay.... In most cases, performance is rigorously measured by comparing the outcomes of individuals referred to the service provider relative to the outcomes of a comparison or control group that is not offered the services....

PFS projects generally include an operating loan from private funders who provide upfront capital in exchange for the lion's share of the government payments that become available if the performance targets are met. If the targeted level of outcomes is achieved, the loan is repaid with interest from the government's performance payments. If the minimum outcomes are not achieved, investors can lose all of their principal.

The United Kingdom Government, who was the first government to implement an SIB and has been the most active in SIB projects to describe SIBs in the following terms:

Rather than focusing on inputs... or outputs... SIBs are based on achieving social 'outcomes' ...[that] are predefined and measurable.... [I]nitial funding is paid for by investors to cover the costs of the project. The provider carries out the project, and the investor is paid by the government according to the results achieved, at specific points agreed in the contract....Investors risk losing money if the service doesn't achieve its outcomes.... Any non-government organisation can become an investor in an SIB. (Cabinet Office, 2013)

While the United Kingdom and the USA have been leaders in SIB implementation, Australia and Canada also have multiple SIB projects that have been initiated. Social Impact Bonds in Australia more commonly referred to as 'Social Benefit Bonds' (SBBs) and are proceeding at the state level. The State of New South Wales, who has launched two SIBs, define them as follows:

A social benefit bond (also known as a social impact bond) is a financial instrument that pays a return based on achieving agreed social outcomes. It is a special type of payment-by-results contract, where private investors provide working capital to a service provider to deliver an intervention. If the provider achieves the agreed social outcomes, this can result in savings to the government in the form of future avoided costs. Part of these savings is then used to repay the upfront investment plus a financial return. (Office of Social Impact Investment, 2017)



The Canadian Government has participated in two SIB projects to date and while noting there are various SIB forms, defines one model as:

...a contract between a government and an external organization, in which the government identifies desired social results and commits to pay the external organization an agreed-upon amount of money if these results are achieved. Typically, investors provide the money to finance an organization to deliver a service. If the agreed-to results are achieved, investors may receive up to 100 percent of the original investment as well as a financial return. If the results are not achieved, the government does not pay. (Government of Canada, 2015)

SIBs in Canada are also proceeding at the provincial level in Saskatchewan and Ontario, with both provinces utilizing similar definitions, with Ontario also referencing that “financial returns are paid to investors out of the savings realized by government” (Government of Saskatchewan, 2015; Government of Ontario, 2017).



# Appendix B: Sector Proportion of SIBs, by Country

	<u>Child and Family Welfare</u>	<u>Criminal Justice</u>	<u>Education and Early Years</u>	<u>Environment and Sustain-ability</u>	<u>Health</u>	<u>Housing / Homelessness</u>	<u>Workforce Development</u>
Australia	43%	14%	0%	0%	14%	29%	0%
Austria	0%	0%	0%	0%	0%	0%	100%
Belgium	0%	0%	0%	0%	0%	0%	100%
Canada	25%	0%	25%	0%	25%	0%	25%
Finland	0%	0%	0%	0%	0%	0%	100%
France	0%	0%	0%	0%	0%	0%	100%
Germany	50%	0%	0%	0%	0%	0%	50%
Israel	0%	0%	0%	0%	50%	0%	50%
Japan	0%	0%	0%	0%	100%	0%	0%
Netherlands	0%	13%	0%	0%	0%	0%	88%
New Zealand	0%	0%	0%	0%	0%	0%	100%
Portugal	25%	0%	25%	0%	0%	0%	50%
South Korea	0%	0%	50%	0%	0%	0%	50%
Sweden	0%	0%	100%	0%	0%	0%	0%
Switzerland	0%	0%	0%	0%	0%	0%	100%
UK	15%	3%	8%	0%	10%	30%	35%
USA	10%	35%	10%	5%	10%	25%	5%
<b>All SIBs</b>	<b>14%</b>	<b>10%</b>	<b>9%</b>	<b>1%</b>	<b>11%</b>	<b>19%</b>	<b>36%</b>

# Appendix C: Reported SIB Maximum and Expected Investor Returns<sup>1</sup>

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
1.Peterborough	UK	Criminal Justice	Sep- 10	100%	6.1%	13.0%	7.5%	In full	Social Finance (2018)
2.West Midlands (Birmingham and Solihull)	UK	Workforce Development	Apr- 12	100%	2.8%			Partial+	DWP (2016, p. 6)
3.East London (Tower Hamlets, Islington and Hackney	UK	Workforce Development	Apr- 12	100%	43.3%			In full	Social Finance (2018)
4.Greater Merseyside	UK	Workforce Development	Apr- 12	100%	36.9%			In full	Social Finance (2018)
5.Nottingham	UK	Workforce Development	Apr- 12	100%	16.0%			In full	Social Finance (2018)
6.Perth and Kinross	UK	Workforce Development	Apr- 12	100%				Partial+	DWP (2016, p. 6)
7.East London (Stratford, Canning Town, Royal Docks, and Cathall)	UK	Workforce Development	Apr- 12	100%	43.2%			Partial+	DWP (2016, p. 6)
8.New York	USA	Criminal Justice	Aug- 12	25%	6.8%	6.9%	3.9%	no	Social Finance (2018)
9.Cardiff and Newport	UK	Workforce Development	Nov -12	100%	53.9%			Partial+	DWP (2016, p. 6)
10.London	UK	Housing/Ho melessness	Nov -12	100%	39.3%			Partial	Social Finance (2018)
11.London	UK	Housing/Ho melessness	Nov -12	100%	26.0%			Partial	Social Finance (2018)

<sup>1</sup> Data sources include Gustafsson-Wright, Gardiner and Putcha (2015), Nonprofit Finance Fund (2017), and Social Finance (2018). Project documentation such as fact sheets and stakeholder websites were consulted in some cases to confirm or verify interest rate and investor return details. Some figures are based on author's calculation of annualized rates of return based on reported total return on investment. Figures include both Internal Rate of Return methodology and simple annualized return rate on total investment. In the case of multiple entries for return rates, a simple unweighted arithmetic mean of returns for differing investor classes is presented.

<sup>2</sup> The maximum aggregate per annum interest rate ( $i$ ) is the annualized return rate based on reported maximum outcomes payment available ( $P_{max}$ ) and total funds invested ( $I$ ), including in some cases grant funding. Letting  $t$  be the contract duration in months, it is calculated as  $i = \left(\frac{P_{max}}{I}\right)^{\frac{12}{t}} - 1$ .

<sup>3</sup> 'Partial+' refers to the case where we were able to identify that the investors were at least partially repaid, for example for some years of the project and/or some outcome realizations, but were unable to confirm if full repayment had been made.

Table 17

Reported SIB Maximum and Expected Investor Returns

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
12.Greater Manchester	UK	Workforce Development	Nov -12	100%	49.9%			In full	Social Finance (2018)
13.Essex	UK	Child and Family Welfare	Nov -12	100%	10.7%	12.0%	10.0%	Initial years; On track	Social Finance (2018)
14.Thames Valley	UK	Workforce Development	Nov -12	100%	49.8%			In full	Social Finance (2018)
15.West London	UK	Workforce Development	Nov -12	100%				Partial+	DWP (2016, p. 6)
16.New South Wales	Australia	Child and Family Welfare	Jul-13	100%	14.3%	30.0%		On track	Loxley (2017)
17.Sydney	Australia	Child and Family Welfare	Aug-13	50%	14.1%	15.0%	12.0%	Initial years; On track	Loxley (2017)
18.Salt Lake County	USA	Education and Early Years	Sep-13	100%		7.3%		Initial years; On track	Social Finance (2018)
19.Augsburg,	Germany	Workforce Development	Sep-13	100%	0.0%	3.0%		In full	Shaw (2017)
20.United Kingdom	UK	Child and Family Welfare	Sep-13	100%				Unknown	Social Finance (2018)
21.Rotterdam	Netherlands	Workforce Development	Dec-13	66%	4.8%	12.0%		On track	Social Finance (2018)
22.New York City and Rochester	USA	Criminal Justice	Dec-13	90%	8.9%	12.5%	7.0%	Unknown	Social Finance (2018)
23.Boston, Chelsea and Springfield	USA	Criminal Justice	Jan-14	100%	6.0%	14.5%	3.5%	Unknown	Social Finance (2018)
24.Brussels	Belgium	Workforce Development	Apr-14	100%	8.0%	6.0%		Unknown	Social Finance (2018)
25.Saskatoon	Canada	Child and Family Welfare	May -14	100%	5.4%	5.0%		On track	Loxley (2017)
26.Manchester	UK	Child and Family Welfare	Jun-14	100%				Unknown	Social Finance (2018)
27.Birmingham	UK	Child and Family Welfare	Jul-14	100%				Unknown	Social Finance (2018)
28.Chicago	USA	Education and Early Years	Oct-14	100%	19.5%		6.0%	Initial years; On track	Sanchez (2016, p. 57)
29.Massachusetts	USA	Housing/Homelessness	Dec-14	100%	9.4%	5.3%		Initial years; On track	United Way of Massachusetts Bay and Merrimack Valley (2018)

Table 17

Reported SIB Maximum and Expected Investor Returns

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
30.Cuyahoga County	USA	Child and Family Welfare	Dec- 14	100%	4.6%		2.3%	Unknown	Social Finance (2018)
31.Gloucestershire	UK	Housing/Ho melessness	Jan- 15	100%	67.2%			Initial years; On track	ICF Consulting Services (2017, p. 24)
32.Lisbon	Portugal	Education and Early Years	Jan- 15	100%			2.0%	Partial	Maze (2017)
33.Liverpool and Knowsley	UK	Housing/Ho melessness	Jan- 15	100%	29.7%			Initial years; On track	ICF Consulting Services (2017, p. 24)
34.Greenwich (Manchester, Oldham and Rochdale)	UK	Housing/Ho melessness	Jan- 15	100%	37.2%			Initial years; On track	ICF Consulting Services (2017, p. 24)
35.Leicestershire and Derbyshire	UK	Housing/Ho melessness	Jan- 15	100%	71.0%			Initial years; On track	ICF Consulting Services (2017, p. 24)
36.Birmingham	UK	Housing/Ho melessness	Jan- 15	100%	28.8%			Initial years; On track	ICF Consulting Services (2017, p. 24)
37.West Yorkshire (Kirklees, Calderdale and Wakefield, Yorkshire and the Humber)	UK	Housing/Ho melessness	Jan- 15	100%				Initial years; On track	ICF Consulting Services (2017, p. 24)
38.Newcastle	UK	Health	Mar -15		8.5%			On track	Social Finance (2018)
39.Newcastle, Northumberland, South Tyneside, North Tyneside, Gateshead, Durham, and Sunderland	UK	Housing/Ho melessness	Mar -15	100%				Initial years; On track	ICF Consulting Services (2017, p. 24)
40.Utrecht	Netherlan ds	Workforce Development	Apr- 15			6.0%		Unknown	Social Finance (2018)
41.Greater Manchester	UK	Workforce Development	Apr- 15		0.0%			On track	Social Finance (2018)
42.London	UK	Workforce Development	Apr- 15					Unknown	Social Finance (2018)
43.Greater Merseyside	UK	Workforce Development	Apr- 15					Unknown	Social Finance (2018)
44.Sheffield	UK	Workforce Development	Apr- 15					Unknown	Social Finance (2018)
45.Bern	Switzerlan d	Workforce Development	Jun- 15	5%		1.0%		Unknown	Social Finance (2018)

Table 17

Reported SIB Maximum and Expected Investor Returns

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
46. Worcestershire	UK	Health	Jul-15		21.2%	2.6%		Unknown	Social Finance (2018)
47. Rotterdam	Netherlands	Workforce Development	Sep-15			10.0%		On track	Klaassen (2017, p. 7)
48. Upper Austria	Austria	Workforce Development	Sep-15	100%	0.0%	1.0%		Unknown	Social Finance (2018)
49. Santa Clara County	USA	Housing/Homelessness	Sep-15		2.5%		2.3%	Unknown	Social Finance (2018)
50. Haifa & Tel Aviv	Israel	Workforce Development	Nov-15			10.0%	5.0%	Unknown	Social Finance (2018)
51. Utrecht	Netherlands	Workforce Development	Nov-15			10.0%		Unknown	Social Finance (2018)
52. Helsinki	Finland	Workforce Development	Nov-15				10.0%	On track	Social Finance (2018)
53. Haringey, Staffordshire & Tower Hamlets	UK	Health	Jan-16		93.5%			Unknown	Social Finance (2018)
54. South Carolina	USA	Health	Feb-16		-18.5%			Unknown	Social Finance (2018)
55. Denver	USA	Housing/Homelessness	Feb-16		5.6%		3.5%	Unknown	Social Finance (2018)
56. Israel	Israel	Health	Mar-16					Unknown	Social Finance (2018)
57. Norrköping	Sweden	Education and Early Years	May-16	60%		4.7%		Unknown	Social Finance (2018)
58. Netherlands	Netherlands	Criminal Justice	Jun-16		3.3%	3.9%		Unknown	Social Finance (2018)
59. Adelaide	Australia	Housing/Homelessness	Jun-16		8.3%	13.0%	8.5%	Unknown	Social Finance (2018)
60. New South Wales	Australia	Criminal Justice	Jul-16					Unknown	Social Finance (2018)
61. Regina	Canada	Education and Early Years	Sep-16	100%	3.0%	1.3%		Unknown	Social Finance (2018)
62. Enschede	Netherlands	Workforce Development	Sep-16		10.1%	10.0%		Unknown	Social Finance (2018)
63. Eindhoven	Netherlands	Workforce Development	Jun-16			3.2%		Unknown	Social Finance (2018)
64. Seoul	South Korea	Education and Early Years	Jul-16					Unknown	Social Finance (2018)

Table 17

Reported SIB Maximum and Expected Investor Returns

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
65.Connecticut	USA	Child and Family Welfare	Sep- 16	100%	7.2%		5.9%	Unknown	Social Finance (2018)
66.Washington, D.C.	USA	Environment and Sustainability	Sep- 16	13%	0.2%	6.4%	3.4%	Unknown	Social Finance (2018)
67.BC, SK, ON	Canada	Workforce Development	Oct- 16			15.0%		Initial years; On track	Colleges and Institutes Canada (2018)
68.Toronto and Vancouver	Canada	Health	Oct- 16	50%		8.8%		Unknown	Social Finance (2018)
69.Salt Lake County	USA	Criminal Justice	Dec- 16		9.2%	10.2%	3.5%	Unknown	Social Finance (2018)
70.Salt Lake County	USA	Housing/Ho melessness	Dec- 16		-1.1%	11.1%	3.5%	Unknown	Social Finance (2018)
71.rural	France	Workforce Development	Jan- 17					Unknown	Social Finance (2018)
72.urban	France	Workforce Development	Jan- 17					Unknown	Social Finance (2018)
73.Auckland	New Zealand	Workforce Development	Feb- 17					Unknown	Social Finance (2018)
74.Lambeth	UK	Education and Early Years	Feb- 17					Unknown	Social Finance (2018)
75.Greater Boston	USA	Workforce Development	Mar -17		3.2%		6.5%	Unknown	Social Finance (2018)
76.North Somerset	UK	Child and Family Welfare	Mar -17					Unknown	Social Finance (2018)
77.Gyeonggi	South Korea	Workforce Development	Mar -17					Unknown	Social Finance (2018)
78.Tulsa, Oklahoma	USA	Criminal Justice	Apr- 17		7.1%			Unknown	Social Finance (2018)
79.Kobe	Japan	Health	Apr- 17					Unknown	Social Finance (2018)
80.Tokyo (Hachioji)	Japan	Health	Apr- 17					Unknown	Social Finance (2018)
81.Queensland	Australia	Child and Family Welfare	Jun- 17	50%		12.0%	7.0%	Unknown	Social Finance (2018)
82.New South Wales	Australia	Health	Jun- 17	0%	15.2%		7.5%	Unknown	Social Finance (2018)
83.Uusimaa and Southwest Finland	Finland	Workforce Development	Jun- 17		1.4%		10.0%	Unknown	Social Finance (2018)

Table 17

Reported SIB Maximum and Expected Investor Returns

(1) Location	(2) Country	(3) Sector	(4) Mth Lau nch ed	(5) Max. Loss of Inv.	(6) Max ag. p.a. intrst. rate <sup>2</sup>	(7) Max. p. a. return	(8) Expected /Target return	(9) Investor s repaid by Outcome Funder? <sup>3</sup>	(10) Source for outcome status
84.Fundao	Portugal	Workforce Development	Jul- 17					Unknown	Social Finance (2018)
85.Porto	Portugal	Workforce Development	Jul- 17					Unknown	Social Finance (2018)
86.Porto	Portugal	Child and Family Welfare	Jul- 17					Unknown	Social Finance (2018)
87.Manchester	UK	Housing/Ho melessness	Nov -17		28.3%			Unknown	Social Finance (2018)
88.Los Angeles	USA	Housing/Ho melessness	Oct- 17		2.8%	2.8%	2.3%	Unknown	Social Finance (2018)
89.Ventura County, CA	USA	Criminal Justice	Nov -17		1.9%		5.7%	Unknown	Social Finance (2018)
90.Northampton shire	UK	Housing/Ho melessness	Oct- 17					Unknown	Social Finance (2018)
91.District of Osnabrück	Germany	Child and Family Welfare	Sep- 17					Unknown	Social Finance (2018)
92.London Boroughs of Lambeth, Southwark and Lewisham	UK	Health	Dec- 17					Unknown	Social Finance (2018)
93.Queensland	Australia	Housing/Ho melessness	Sep- 17	40%		11.0%	7.5%	Unknown	Social Finance (2018)
94.Brent	UK	Housing/Ho melessness	Sep- 17					Unknown	Social Finance (2018)
95.Netherlands	Netherland s	Workforce Development	Nov -17		6.4%	10.0%		Unknown	Social Finance (2018)
96.Bradford	UK	Education and Early Years	Nov -17					Unknown	Social Finance (2018)
97.London	UK	Child and Family Welfare	Jan- 18		22.1%			Unknown	Social Finance (2018)
98.Alameda County	USA	Criminal Justice	Sep- 17					Unknown	Social Finance (2018)
99.London	UK	Education and Early Years	Apr- 17					Unknown	Social Finance (2018)
100.Kent County	USA	Health	Aug- 16					Unknown	Social Finance (2018)

# Appendix D: Description of Value for Money Analysis in Applied Public Finance

Value for Money (VfM) analysis is an applied analytical approach implemented to assist public sector decision makers faced with competing procurement options, specifically a PPP model and a conventional model. The VFM accounting framework was pioneered by the Private Finance Initiative in the UK and has been adopted extensively in Canada and other advanced industrialized countries (Loxley, 2010, p. 60; Morillos & Amekudzi, 2008; Burger & Hawkesworth, 2011, pp. 11-12). Both the Value for Money (VFM) analysis and the model above are specific and constrained forms of cost benefit analysis (CBA). CBA was first integrated with formal welfare economic analysis by Otto Eckstein in 1958, although the approach has a long tradition in applied public finance with origins going back to at least 1808 (Hanley & Spash, 1993). In this welfare economics context, CBA provides a decision rule for undertaking an action, generally an investment, in the presence of some form of market failure such that the present value of private gains from such an undertaking do not reflect the present value of social benefits due to prices of inputs and/or outputs being different than the present value of social benefits (Boadway & Bruce, 1984, pp. 26-27, 292-297). This process involves calculating the cost and benefits based on shadow prices that correct prices for deviations from market prices, determining and incorporating the impacts of externalities, and applying present value calculations.

As VFM analysis and the government procurement framework outlined above are forms of customized CBA, they have some similarities. Both either implicitly or explicitly provide decision rules for a government decision maker who is selecting between competing procurement models



where a project can be delivered either by a single firm or by more than one firm. The approaches however are customized and constrained in different ways, and put emphasis on different attributes of the problem at hand. The model above in Section IV explicitly proposes a source for why a bundled contract structure may be more efficient, founded in microeconomic principal-agent theory, and derives the optimum contract structure for government. VFM analysis does not derive an a priori rationale for why one procurement model may be more efficient than another; it is an accounting framework to explicitly compare variations in categorized costs between the two models. In doing so however, VFM analysis highlights the importance of costs either abstracted away from or deemphasized in the typical incentive theory framework, including transaction costs and the cost of financing under the differing procurement models. This less abstract methodology of VFM brings it closer to an applied decision-making context, where the policy debate around SIBs is taking place. The VFM analysis also focuses on cost differentials between delivery methods, which presumes that the project being delivered assumes the project outcome or benefit being delivered is fixed or predetermined. This makes VFM more of a “cost effectiveness analysis” as opposed to a CBA.<sup>4</sup>

The VFM approach is a simple rules-based test implemented by public sector decision makers. The approach tallies an adjusted net present cost of a project under the conventional delivery model, called the *public sector comparator* which is compared to a *shadow bid* based on the expected net present cost of delivery through the PPP framework. The difference between the public-sector comparator and PPP shadow bid, if positive, is termed the *value-for-money* provided by the PPP delivery model. VFM analysis is highly general in the sense that it can encompass any type of PPP contract structure, be it one with user fees, state-contingent subsidies, minimum revenue guarantees, fixed or flexible term contracts, etc., and various assumptions regarding contract enforceability and information asymmetry. Grout and Sonderregger (2006) outline the conditions under which a simple-money based test such as the cost-based VFM analysis would be equivalent to a full cost-benefit

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<sup>4</sup> See Weinrott, Jones, & Howard (1982, p. 179) and Welsh, Farrington & Gowar (2015, pp. 457-458) who highlight this distinction.

analysis: First, there must be no excess profits realized such that the financial cost to government of the project is equal to the private sector delivery cost. Secondly, the two delivery models must provide the same expected social benefit.<sup>5</sup> The final condition is that the same discount rate be applied when calculating the net present value of benefits delivered under each delivery model.

With these conditions met, the appropriate normative condition for determining whether a PPP is the superior delivery method reduces to whether the benefits from bundling under a PPP outweigh any increase to financing, transaction or other costs. If a change in quality of service is to be expected, this would need to be accounted for as well. For a public-sector decision maker seeking the socially optimal delivery contract for a social service contract, the problem again in general is the same: The SIB will be superior if it provides a better solution to agency problems, after accounting for any quality adjustments. This similarity allows for a standard value-for-money approach to be used to evaluate the public benefit of proceeding with an SIB.

Under a VFM accounting analysis the total costs of the PPP and conventional model are subdivided into their various components.<sup>6</sup> *Value for money* is calculated as cost difference between the cost of the public sector comparator (PSC), which assumes the conventional delivery method, and the cost of the shadow bid under the alternative delivery method (SB). The shadow bid and the public-sector comparator are equal to the sum of each delivery model's component costs to the public-sector entity over the life of the project.<sup>7</sup> In a VFM analysis, costs are distributed over time and calculated in expected present value terms through the application of a discount rate.<sup>8</sup> VFM

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<sup>5</sup> Note that any savings generated to government as a result of the project or program would be captured as part of this benefit, so that the restriction of the choice set in the standard SIB framework to projects or programs that generate financial savings does not result in any additional positive impact on overall social welfare as it is assumed accounted for.

<sup>6</sup> See HM Treasury Taskforce (1999), Morillos & Amekudzi, (2008), and PPP Canada (2011) for descriptions of the value-for-money assessment process.

<sup>7</sup> For simplicity this model compares a conventional model to a single alternative, but in practice multiple alternatives may be considered. In particular, in the PPP case a design-build model provides an intermediate comparator, as would a PBR model based on equity or debt financing by the service provider in the SIB context.

<sup>8</sup> For example,  $B = \int_0^{\infty} E[B_t]e^{-\rho t}$  where  $E$  is the expectations operator,  $e$  is the base of the natural logarithm, and  $\rho$  is the discount rate. The determination of the appropriate discount rate or rates is not necessarily a straight forward exercise, and the selection of discount rate can carry significant weight in the outcome of VFM analysis. See Loxley (2011, pp. 66-76) and Morillos and Amekudzi (2008, pp. 122-123).

accounting generates the decision-making rule for public sector entity *ex ante* to the project being procured and assumes the decision to undertake the project has been made based on a preliminary cost-benefit assessment; what remains is the determination of the appropriate delivery model.<sup>9</sup>

There exists some variation in how costs are categorized in VFM analyses, but generally the cost of PSC is calculated as the sum of the total lifecycle costs, including 'retained risks' of delivering the service publicly, plus a competitive neutrality adjustment. Competitive Neutrality accounts for any differences in taxes paid to government by the contractor under the conventional and alternative delivery models, as well as any indirect subsidy or in-kind support encompassed in the public-sector delivery model that the private sector entity would not have access to in the alternative model.<sup>10</sup> The cost of service delivery can be further broken down categorized into various components such as: administrative costs, including transaction costs such as procurement costs, legal, technical and financial advisor fees and contract management expenses incurred by the government;<sup>11</sup> financing costs; and transfers to the various service providers at the differing stages delivery, for example at the design and construction stage versus the operations phase. The cost of the SIB is calculated as the expected costs under the PPP approach, including retained risks, administration, plus payments to the PPP consortium. These consortium payments can also be divided into their various components, including financing costs and transfers to the various service providers for differing stages of the project.

Retained risks feature prominently in value-for-money analyses and it is often through risk transfer that PPPs from an *ex ante* standpoint are determined to provide value-for-money (Loxley, 2010, pp. 66-73; Morillos & Amekudzi, 2008). Retained risk cost is the estimated monetary cost to

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<sup>9</sup> While I assume that the administrators undertaking the analysis are doing so in good faith, it has been noted by others that public officials may have an incentive to misrepresent costs, for example, to secure funding for projects based on their individualized, non-altruistic preferences over projects being considered. For example, see Maskin and Tirole (2008).

<sup>10</sup> Typically, the tax differential takes the form of taxes that would not be paid under the conventional delivery framework but would be paid if purchased by a private entity in a market transaction, but there are cases where this can work in the opposite direction as well (Loxley, 2010, p. 63).

<sup>11</sup> It is assumed that the government directly pays auxiliary costs in all contract structures. See Levin and Tadelis (2010) for further discussion of the higher transaction cost versus delivery efficiency trade-off entailed with contracting-out government services.

the public-sector entity in a given delivery framework produced by a quantitative risk assessment with respect to contingent obligations weighted by their probability of being realized. The treatment of risk in a VFM analysis is somewhat peculiar from a principal-agent modelling perspective, and the meaning of *risk* is not equivalent in the two contexts. In the principal-agent model, estimates of future costs are unbiased and the uncertainty associated with future contingencies only imposes a cost if the holder is risk averse. In VFM accounting, *retained risk* is assumed to impose a positive cost to government. This either implies that estimates of other costs are negatively biased, or the government is risk averse.<sup>12</sup> In the principal-agent framework, modeling a government as risk averse is not the norm given the ability of government to self-insure and its powers to raise revenue through taxation (Hart, 2003, p. C75).<sup>13</sup> In our model in the main body of the paper we dispense with the distinction between costs labelled as retained risk and the other expected service delivery costs, treat service delivery costs as a random variable, and assume the government is risk neutral. We also allow benefits to vary, making our model more closely tied to a full CBA as opposed to a VfM type cost effectiveness approach.

It should also be highlighted that having a social service be able to generate benefits in excess of its cost is not a universally accepted criterion for proceeding with service delivery. Standard economic theory calls for an adjustment based on the 'opportunity cost' of the resources dedicated to implementation, approximated by some market-based assessment of returns on financial assets. Applying this particular cost-benefit method for projects whose impacts project well into the future also relies upon the selection of a discount rate to reduce the magnitude of future benefits and costs

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<sup>12</sup> While we assume here that the administrators undertaking the analysis are doing so objectively, it has been noted by others that public officials may have an incentive to misrepresent costs, for example, to secure funding for projects based on their individualized, non-altruistic preferences over projects being considered. For example, see Maskin and Tirole (2008).

<sup>13</sup> This is done through powers of taxation and debt issuance by spreading risk amongst a large number of people, relative to private firms who are lesser in this capacity and tend to be more risk averse (Arrow & Lind, 1970, Chambers & Echenique, 2012). Private profit-maximizing firms will not accept incremental risk through contract negotiations without compensation, and if they are risk averse, there is no gain from a Welfarist perspective by transferring risk from government to a private firm unless it is more than offset by some other source of efficiency gain from bundling as part of the risk transfer.

due to the fact that their impact is delayed and the assumption that humans naturally value the present with more intensity than the future.

Using this approach, Heckman (2006, p. 1901), for example highlights that while investment in preschool, school, and post-secondary job training interventions all have positive social returns, only investments in early childhood development clearly generate a positive payoff above and beyond the opportunity costs of these investments, the benchmark for the economic efficiency of resource allocation. Heckman, while recognizing that equity considerations also play a role in informing social expenditure decisions, uses these results to highlight the pitfalls of waiting “too long to compensate” for social inequity that is clearly linked back to early childhood disadvantage (2006, p. 1901).

It should be noted however the assumptions behind the opportunity cost, discount rate approach to cost benefit analysis (CBA) however are not universally accepted. At their root these concepts are founded in neoclassical economic assumptions of human behavior and aggregate supply-constrained theoretical perspectives on the functioning and limitations on how economies operate and evolve in respond to shocks and intervention. Structuralist and Post Keynesian approaches – see for example Taylor (2010) – emphasize the aggregate demand constrained nature of modern economies, and other heterodox economists have been critical of the role of discount rate approaches that privilege current over future outcomes - see for example Stanford (2015, pp. 86-88). Even if one accepts the discount rate approach, the selection of the particular rate is a contentious issue and has a large impact on CBA outcomes, placing heavy weight on a theoretically contested notion (Loxley, 2010, pp. 63-66).

# Appendix E: Pay-by-Results with Public Finance

## a) Unbundled Delivery with Pay by Results Operating Payments

Under an unbundled pay by results procurement two contracts are issued. A fixed price contract equal to  $T_D^{PbR} = \alpha_D^{PbR}$  is issued to the designer, possibly due to the impracticality of making payments to the designer contingent on outcomes that will be realized well after contractual obligations are fulfilled. The following performance-based contract is issued to the operator:<sup>14</sup>

$$T_O^{PbR}(B) = \alpha_O^{PbR} + \beta B$$

Since the designer receives a fixed price contract and is not impacted by operating costs, the designer again has no incentive to invest quality-enhancing effort or quality shading and therefore  $i_1 = e_1 = 0$ . Also, again, the public financier is subject to hold-up and therefore  $i_2 = e_2 = 0$ . Based on this, the operator optimizes its level of effort to maximize expected utility:

$$\begin{aligned} E[U_O^{PbR}] &= E[T_O^{PbR}(B) - C_O] - \psi_{i_3}(i_3) - \psi_{e_3}(e_3) - \psi_{f_3}(f_3) - R + \varphi_1 + \varphi_3 \\ (i_3^{PbR}, e_3^{PbR}, f_3^{PbR}) &= \arg \max_{i,e,f \geq 0} \left[ E[U_O^{PbR}] \right. \\ &= \alpha_O^{PbR} + \beta b_0 - c_0 + (\beta b_3 + \delta_3)i_3 - (\beta d_3 - \gamma_3)e_3 + \chi_3 f_3 - \frac{i_3^2}{2} - \frac{e_3^2}{2} - \frac{f_3^2}{2} \\ &\quad \left. - \frac{r(\sigma_\varepsilon^2 + \sigma_\eta^2 \beta^2)}{2} + \varphi_1 + \varphi_3 \right] \\ i_3^{PbR-O} &= \begin{cases} \beta b_3 + \delta_3 & \text{if } \beta b_3 + \delta_3 \geq 0 \\ 0 & \text{if } \beta b_3 + \delta_3 < 0 \end{cases} \end{aligned}$$

<sup>14</sup> For simplicity a continuous contract structure is assumed, while in reality most SIB contracts have discrete jumps in payment based on certain thresholds of realized benefit levels.

$$e_3^{PbR-0} = \begin{cases} \gamma_3 - \beta d_3 & \text{if } \gamma_3 - \beta d_3 \geq 0 \\ 0 & \text{if } \gamma_3 - \beta d_3 < 0 \end{cases}$$

$$f_3^{PbR-0} = \chi_3$$

When  $\beta b_3 + \delta_3 < 0$ , the flow-through in benefits received due to quality enhancing effort are insufficient to cover the increase in operating cost, so no effort of this type is expended. When  $\beta b_3 + \delta_3 \geq 0$ , the quality enhancing effort level exerted by the operator  $i_3^{PbR}$  equals the proportion of marginal direct benefit passed on by the government, plus the full marginal benefit of cost reduction since the operator is fully responsible for costs. When  $\gamma_3 - \beta d_3 < 0$ , the flow through of the decline in benefit due to quality shading is sufficient to completely offset the cost reduction, and the operator does not engage effort in this type of activity. When  $\gamma_3 - \beta d_3 \geq 0$ , the marginal benefit to the operator of quality shading is positive and equal to the marginal cost reduction net of the flow-through of benefit reduction.

The government sets  $\beta$  to maximize expected social welfare, given  $i_3^{PbR}$  and  $e_3^{PbR}$ . When  $\beta b_3 + \delta_3 < 0$  and  $\gamma_3 - \beta d_3 < 0$  where neither type of effort is utility enhancing,  $e^{PbR} = i^{PbR} = \mathbf{0}$ ,  $\beta = 0$ , and fixed cost contracts are offered. In this case, the PbR scenario will be superior to the conventional model when the benefit of forgone quality shading in the conventional model is sufficient to offset the increase in risk premium as well as any increase in transaction costs:

$$\left( d_3 \gamma_3 - \frac{\gamma_3^2}{2} \right) > \frac{r(\sigma_\eta^2 \beta^2)}{2} + (A^{PbR} - A^C)$$

When  $\beta b_3 + \delta_3 < 0$  and  $\gamma_3 - \beta d_3 \geq 0$  such that quality shading is utility enhancing in the PbR scenario but quality enhancing effort is not:

$$\beta_0^{PbR} = \arg \max_{\beta} \left[ E[P_0^{PbR}] \right]$$

$$= b_0 - c_D - c_0 - (d_3 - \gamma_3)e_3^{PbR} + \chi_3 f_3^{PbR} - \frac{(e_3^{PbR})^2}{2} - \frac{(f_3^{PbR})^2}{2} - \frac{r(\sigma_\varepsilon^2 + \sigma_\eta^2 \beta^2)}{2}$$

$$+ 2\varphi - A_0^{PbR} \Big]$$

$$\beta_0^{PbR} = \frac{d_3^2}{d_3^2 + r\sigma_\eta^2}$$

The government pays the operator based on results but does not fully pass on the reduction in social benefit from quality shading due to contractor risk aversion.<sup>15</sup> As the marginal detrimental impact of quality shading increases, the government increases the flow through, such that as  $d \rightarrow \infty$ ,  $\beta_0^{PbR} \rightarrow 1$ , and as  $d \rightarrow 0$ ,  $\beta_0^{PbR} \rightarrow 0$ . The above solution for  $\beta_0^{PbR}$  moves the quality enhancing effort level of the operator closer to the social optimum, increasing social welfare relative to the fixed price contract model, but still remaining below the social optimum.

An equivalent result is obtained when  $\beta b_3 + \delta_3 \geq 0$  and  $\gamma_3 - \beta d_3 < 0$  such that is quality enhancing effort utility enhancing for the operator, but quality shading is not, such that:

$$\beta_0^{PbR} = \frac{b_3^2}{b_3^2 + r\sigma_\eta^2}$$

Finally, when both types of effort are utility enhancing for the agent, the optimum  $\beta_0^{PbR}$  equals:

$$\beta_0^{PbR} = \frac{b_3^2 + d_3^2}{b_3^2 + d_3^2 + r\sigma_\eta^2}$$

Now that the operator is also exerting quality-enhancing effort and quality shading effort, the government increases  $\beta$  to incentivize a higher internalization of the welfare effects.

When positive values of  $i$  and  $e$  are optimal, the PbR model will deliver superior results relative to the conventional model based on the degree to which the increased welfare due to the partial internalization of the externalities associated with investment in quality and quality shading  $\left[ \beta \left( 1 - \frac{\beta}{2} \right) (b_3^2 + d_3^2) \right]$  is sufficient to offset the increase in risk premium and any incremental transaction costs associated with the PbR model, i.e.  $E[W^{PbR}] - E[W^C] > 0$  if:

<sup>15</sup> This result is similar to Iossa and Martimort's (2015, p. 16) unbundled case of a PPP with user fees where the operator retains any surplus revenue.



$$\beta \left(1 - \frac{\beta}{2}\right) (b_3^2 + d_3^2) > \frac{r(\sigma_\eta^2 \beta^2)}{2} + (A_O^{PbR} - A^C)$$

## b) Bundled Pay-by-Results

In the case of a bundled design and delivery, the joint designer-operator receives a similar reimbursement rule to the operator in the unbundled performance-based payment scenario, based on a fixed payment and a portion based on social benefit outcomes:

$$T_{DO}^{PbR}(B) = \alpha_{DO}^{PbR} + \beta B$$

The optimal efforts applied at the operation levels  $i_3^{PbR}$  and  $e_3^{PbR}$  are the same as in the unbundled scenario given that the agent again has full responsibility for operational costs and receives a partial flow-through of benefits. However, unlike the unbundled scenario, the designer-operator now has an incentive to invest in improving program quality at the design stage as well as to undertake quality shading on design. The designer-operator internalizes the direct effects of  $i_1$  and  $e_1$  on social benefits based on the social benefit flow-through and cost function parameters:

$$i_1^{PbR-DO} = \begin{cases} \beta b_1 + \delta_1 & \text{if } \beta b_1 + \delta_1 \geq 0 \\ 0 & \text{if } \beta b_1 + \delta_1 < 0 \end{cases}$$

$$e_1^{PbR-DO} = \begin{cases} \gamma_1 - \beta d_1 & \text{if } \gamma_1 - \beta d_1 \geq 0 \\ 0 & \text{if } \gamma_1 - \beta d_1 < 0 \end{cases}$$

$$f_1^{PbR-DO} = \chi_1$$

The government again sets  $\beta$  to maximize expected social welfare, given  $(\mathbf{i}, \mathbf{e})$ . If none of the non-negativity constraints hold for effort at the design and operations levels, the result is:<sup>16</sup>

$$\beta_{DO}^{PbR} = \frac{b_1^2 + b_3^2 + d_1^2 + d_3^2}{b_1^2 + b_3^2 + d_1^2 + d_3^2 + r\sigma_\eta^2}$$

The joint contractor now has an incentive to expend effort on design quality, but also an incentive to quality shade to reduce costs. A payment structure that incentivizes and shares the impact of these

<sup>16</sup> Again, this is similar to Iossa and Martimort's (2015, p. 16) result in the bundled case of a PPP with user fees where the operator retains any surplus revenue.

efforts is now superior to a fixed price contract for the design component. As the direct marginal impact of efforts on the overall social benefit increases, and the higher the marginal damage of quality shading, the more the optimal contract will be based on outcomes, through a higher ( $\beta$ ). However, given that the contractor is risk averse and social benefit levels are stochastic, it is still not optimal to fully compensate based on the realized benefit level ( $\beta = 1$ ). Again, the PbR model will deliver superior results relative to the conventional model based on the degree to which the marginal benefit in quality investments exceeds the marginal impact of quality shading, and that this effect is sufficient to offset the increased risk premium, any incremental transaction costs, and monopoly rents due to bundling, i.e.  $E[W_{DO}^{PbR}] - E[W^C] > 0$  if:

$$\beta \left(1 - \frac{\beta}{2}\right) (b_1^2 + b_3^2 + d_1^2 + d_3^2) > \frac{r(\sigma_\eta^2 \beta^2)}{2} + (A_{DO}^{PbR} - A^C + U_{DO}^{PbR})$$



# Appendix F: Social Investment and Entrepreneurship Concepts

This appendix reviews a number of conceptual developments related to integration of social concerns with finance and the production of goods and services, including socially responsible investing, social entrepreneurship and innovation, venture philanthropy, Philanthrocapitalism, social finance, the social economy, and social enterprise, that underpin the notion of a convergence or hybridization of the not-for-profit sector with for profit corporate forms. Several of these concepts are used regularly by proponents of SIBs and constitute useful terminology for discussing the motivations of SIB stakeholders.

## a) Socially Responsible Investing

Parallel to the increasing prominence of CSR has been the growth of what has been termed socially responsible investing (SRI) or impact investing. Schueth (2003) defines SRI in the American context “as the process of integrating personal values and societal concerns into investment decision-making” (p. 190) and identifies three mechanisms through which this takes place: *screening*, which assesses companies based on CSR criteria or avoids companies with poor CSR track records; *shareholder advocacy* to change the practices of how corporations operate and encourage greater CSR; and *community investing* which “provides capital to people in low-income, at-risk communities who have difficulty accessing it through conventional channels” (p. 191).

Graff, Zivin and Small (2005) highlight that the two hypotheses of CSR, “disguised profit maximization” and “managerial utility maximization” (p. 8) do not explain why investors would demonstrate a particular preference for SRIs, which empirically have been shown to not outperform

the market (p. 9), as opposed to direct charitable contributions. They frame CSR activity as for-profit firms entering into competition with non-profit entities for philanthropic contributions and the satisfaction it brings to stakeholders who interact with the firm, including investors. The “socially responsible firm” effectively becomes a “hybrid [organization]– neither entirely profit-maximizing nor wholly philanthropic” (p. 1). The distributions of investors’ resources between profit maximizing firms, SRI, and direct donations to charity in this framework are based on investor beliefs regarding the effectiveness of direct charity versus CSI in achieving their philanthropic goals. If investors see both as equally capable, then they will be indifferent between CSR and direct charitable contributions.

For CSR and SRI to be efficient then, they must have some comparative advantage over direct delivery by specialized non-profits, with several proposals having been put forward. These include consumers benefiting from and leveraging the goodwill of the social entrepreneur leading the CSR firm, who forgoes some profit in the exchange for social good; more favorable tax treatment of corporate versus personal charitable contributions; or the ability of the CSR firm to be more efficient, due to for example economies of scope (Baron, 2007, pp. 715-716).

Pauly & Swanson (2017) apply the above modelling approach to SIBs, and suggest that participation by investors in the management of the SIB project provides such efficiency enhancements. SIBs from this perspective then combine elements of CSR, social entrepreneurship, and venture philanthropic approaches. This lays the foundational hypothesis for the efficiency enhancing potential of SIBs, what we argued they must rest upon for its rationale as superior to conventional procurement models. The emphasis on CSR motivations, growing the SRI market, and rehabilitating the image of finance-led capitalism have been clearly referenced in the SIB literature (Fraser, Tan, Lagarde & Mays, 2018, p. 10).

## b) Social Entrepreneurship and Social Innovation

Schumpeter (1947) identified entrepreneurship as a central mechanism in the driving of economic change, defining “the entrepreneur and his function .... [as] simply the doing of new things or the doing of things that are already being done in a new way (innovation)” (p. 151). The entrepreneur is distinguished from the capitalist or his or her designate, the manager, who may not be creative or innovative, and the inventor, who may never move beyond the stage of discovery (pp. 151-152). In fact, the entrepreneur may not be the inventor at all; the identity centres more on “getting new things done” (p. 152) than originality or unique ideas or practice. While highlighting that “the mechanisms of economic change in capitalist society pivot on entrepreneurial activity,” Schumpeter notes that “the function itself is not absent from other forms of society” (p. 151).

Social entrepreneurship then focuses on these other forms, in particular, the application of entrepreneurship to solving problems of a social nature that have more recently been addressed through government, non-profit and philanthropic sectors in advanced economies. In a widely cited definition, Dees (1998b) puts forward that:

Social entrepreneurs play the role of change agents in the social sector, by: Adopting a mission to create and sustain social value (not just private value); Recognizing and relentlessly pursuing new opportunities to serve that mission; Engaging in a process of continuous innovation, adaptation, and learning; Acting boldly without being limited by resources currently in hand; and Exhibiting a heightened sense of accountability to the constituencies served and for the outcomes created. (p. 4)

He also notes that social entrepreneurship has been associated with breaking down transitional boundaries between for-profit, non-profit and public sectors, and that “markets do not work as well for social entrepreneurs” (p. 1) and that “these behaviors should be encouraged and rewarded in those who have the capabilities and temperament for this kind of work”(p. 3), implying that some form of non-market stimulation or assistance is called for.

The idea of social entrepreneurship has generated significant interest and financial support, centred in the United States and Europe, both within and outside academia, including training initiatives, research programs, and dedicated foundations (Defourny & Nyssens, 2010, p. 33; Chell, Nicolopouloua, Karatas-Özkan, 2010, p. 485). SIBs can be viewed as a tool to support social entrepreneurship and generate innovation in social service delivery.

### c) Venture Philanthropy and Philanthrocapitalism

While social innovation proponents advocate entrepreneurial approaches in social program design and delivery, a parallel shift is advocated by some for the role of financiers of non-profit social programs who draw upon the practices of venture capitalists for inspiration (Letts, Ryan, & Grossman, 1997). Labelled *venture philanthropy*, proponents argue this new framework reframes the grantee-donor relationship along several dimensions, including: a more intensive involvement of the donor in the strategic decisions as to how the receiving organization will utilize the funds; a longer term commitment to funding the organization and/or initiative; with the objective often being systems change or social innovation as described above; and more interest in developing the capabilities and infrastructures of organizations receiving the funds; as well as a focus on metrics and outcomes, with an explicit statement of objectives and tracking over time to determine if progress is being made (van Slyke & Newman, 2006, p. 347-348).<sup>1</sup> SIBs then fit very well with the venture philanthropy model. SIBs create a mechanism for venture philanthropists to recycle capital and transform what was previously a donation into equity, allowing them, if successful in meeting targets, to extract funds and move on to the next project, where previously they would need to raise new

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<sup>1</sup> Katz (2005) questions how fundamental a shift venture philanthropy is from long standing practices in philanthropic circles, linking the concept back to notions of *strategic* and *effective* philanthropy focused on outcomes and prevention, which in turn have a long tradition in the American context, going back at least to the Robber Barron era of the early 20<sup>th</sup> century.

funds. They also implicitly rely upon the value added by investors in project management and service provider selection

Philanthrocapitalism is a related but distinct concept from venture philanthropy, focusing in on establishment of foundations by highly successful entrepreneurs who utilize both their wealth and business experience to generate social outcomes. It includes venture philanthropy such that it includes “the application of modern business techniques to giving but also the effort by a new generation of entrepreneurial philanthropists and business leaders to drive social and environmental progress by changing how business and government operate” (Bishop, 2015, p. 474). While not completely new, it is argued that this model has significantly scaled-up the amount of resources being committed to philanthropy of both money and in-kind by the mega-wealthy corporate elite and exported the model globally. Bishop (2015) highlights how the Great Recession opened the window wider for philanthrocapitalists, given how the wealthy were better positioned to emerge well-placed while governments were burdened by fiscal pressures. This has given them disproportionate leverage in setting the global social development agenda, relative to the amount of funds contributed as a proportion of total spending, while at the same time benefiting from CSR-type effects discussed above.

While proponents celebrate the large scale mobilization of private funds for public good, critics highlight parallel with a century of corporate funded philanthropy and how philanthrocapitalists use their influence to directly appropriately and indirectly deploy government resources in an undemocratic fashion (McGoey, 2014).

#### d) Social Enterprises, Social Finance, and the Social Economy

Social enterprises are a vehicle of social entrepreneurship and are generally defined as a revenue generating business driven primarily by a social purpose (Chell et al., 2010, p. 486; Mendell, 2010, p. 248). Social enterprises have been characterized as a hybrid of organizational forms, blending



elements of for-profit, non-profit, civil society, and public institutional models and motivations (Mendell, 2010, pp. 245-246). The specific forms social enterprises take in practice are varied. Some operate under traditional corporate for-profit/share capital or cooperative business forms and may hold third party certification to validate its adherence to social objectives.<sup>2</sup> Social enterprises may also be constituted as either for-profit subsidiaries of non-profit entities or independent non-profit organizations. Specific corporate forms for social enterprise designated in legislation also exist such as the “social cooperative” (Defourny & Nyssens, 2010, p. 33) in Italy, “Community Interest Corporations” (Chew, 2010, p. 610) in the United Kingdom, and the “Benefit Corporation” in the US (Hiller, 2013). In the US this has allowed corporations to legally set objectives other than maximizing shareholder value, a doctrine that has been enforced in the US legal system (Collins & Kahn, 2016).

Some SRI funds focus exclusively on investing in these organizational forms that are structurally committed to social missions, such as social enterprises, cooperatives, charities, or projects explicitly aimed at achieving similar goals. This type of financing, that is specifically targeted at proactivity implementing support for social and environmental objectives, has been termed “social finance” (Moore, Westley, and Nicholls, 2010, p. 116). The broader supply of goods and services by these organizations and the collective context in which they operate has been labelled “the social economy” (Amin, Cameron & Hudson, 2002, pp. 1-2), a label that denotes not only a collective of business types but a broader philosophical and ideological commitment to solidarity, mutualism and independence (Anheier & Salamon, 2006, p. 71).

Based on our assembled data, SIBs are primarily relying on social enterprises and social economy organizations as the service delivery agents in SIB projects. As noted in Table 10, a large majority of service providers, intermediaries and technical assistance providers are non-profit organizations. Out of the 36 for-profit service providers identified, at least 20 were social enterprises in the sense

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<sup>2</sup> Examples include BCorp certification by the BLab organization in the US (Hiller 2013, p. 290-291), Social Enterprise Mark (2018) in the UK, and the Buy Social certification in Canada (Common Good Solutions, 2017).

that had a clearly identifiable social mission. A similar case existed for for-profit intermediaries, with many expressing specific commitment to social innovation, social finance and/or specialization in outcomes-focussed social service delivery as part of their corporate identity. For-profit evaluators and technical assistance providers, however, saw a greater proportion drawn from more traditional finance, accounting and tax, wealth management, and more traditional research firms.