CHAPTER 6

From Traditional to Outcome-based Public-Private Partnerships: Social Impact Bonds

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Abstract Social impact bonds (SIBs) have emerged in recent years as outcome-based public-private partnerships (PPP) for the delivery of welfare services, whereby economic operators’ remuneration is based on their capacity to achieve service outcomes, thus improving contracting authorities’ ability to tackle specific social needs. Despite the different nuances, this chapter discusses whether SIBs can be regarded as a first step to testing the feasibility of linking the investors’ payment to outcomes and, therefore, as a scheme that could be extended to traditional infrastructure-based PPP contracts.

Keywords Social impact bonds • Outcome-based contracts • Social impact • Measurability • Social innovation

6.1 The Rise of SIBs

Using public-private partnerships (PPP) as a policy tool to achieve better effectiveness in the delivery of public services, especially the social ones, requires changing the contract model. Moving from traditional PPP
models—mainly focused on efficiency—contracting authorities (CAs) should switch toward outcome-based PPP, whereby economic operators’ (EOs) remuneration is based on their capacity to achieve service outcomes, thus improving CAs’ ability to tackle specific social needs.

This new approach should be welcomed by that part of the private sector which, in recent years, has been increasingly incorporating societal and environment aspects into its investment decisions, as discussed in Chap. 1.

Among the different forms of social investing, social impact bonds (SIBs) can be defined as public-private plural partnerships, according to Henry Minztberg (2015), with a contractual structure very similar to the availability-based PPP model (i.e. aimed at financing and delivering welfare services). SIBs, indeed, were conceived not only to overcome the typical shortcomings of traditional public and third-sector service provision (i.e. lack of capital, need for performance management, low efficiency, and accountability), but also to bring more innovation to service design and delivery in order to encourage key stakeholders to focus on the achievement of higher social outcomes.

SIBs are an innovative contractual and financing mechanism in which authorities enter into agreements with social service providers, such as social enterprises or non-profit organizations, and private investors to pay for the delivery of predefined social outcomes. SIBs—whose name was first conceived in the UK—are also known as outcome-based contracts (Continental Europe), pay-for-success contracts (US) or pay-for-benefits contracts (Australia). After the first SIB project was launched in the UK in 2010, more than 130 projects, for a total of €370 million, have been implemented at international level to date and more than 70 are in the development phase. Although SIBs were mainly applied in developed countries, they have also been experimented within developing countries, in the form of development impact bonds (DIBs).

In essence, SIBs involve a set of contracts based on a CA’s decision to pay for an improvement with a specific social outcome, but only once it has been achieved by the EO. Authorities can decide to award SIBs in order to improve a particular social outcome or to tackle unmet needs in the social field. Investors provide the upfront capital to deliver the intervention, thus assuming the financial risk. These funds are passed on to service providers, generally through an intermediary, to cover investment

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1 Source: Social Finance, as in September 2020. [https://www.socialfinance.org.uk](https://www.socialfinance.org.uk).
and/or operating costs needed for the delivery of specific actions intended for a selected target group of beneficiaries. If the measurable outcomes agreed upon at the outset are achieved, the CA will repay the investors for their initial investment, plus a return for the financial risks they took. In the case of lower or higher performance in the achievement of the target outcomes, the payment will be, respectively, higher or lower; in the latter case, no payment is due if no outcome is generated. In other words, if the EO is not able to generate the expected outcomes, payment from the CA is reduced, or cancelled, and no return on the investment is generated. With regards to this financial structure, in spite of their name, SIBs cannot be regarded as bonds in the conventional sense since the capital invested is similar to a riskier equity investment, generally provided by one or few investors.

Given the set of contracts involved, the upfront capital provided by private investors and the payment made by the CA (provided predetermined performance standards are met) SIBs have been regarded as an expansion of the long-term infrastructure PPP model into social program delivery. However, the focus of this form of partnership is no longer an infrastructure-based service, as in traditional PPP schemes, but social issues that require new approaches to be tackled. Indeed, the SIB model fosters not only efficiency—in terms of on-time, on-budget, and on-quality delivery—but also effectiveness, in terms of actual impact and value generated for society. In other words, SIBs encourage social innovation, which occurs at the intersection of the public, private, and social sectors.

A classic SIB scheme involved a plurality of stakeholders, as shown in Fig. 6.1. On the one hand, we have the private sector—encompassing both private investors (providing upfront capital) and non-profit service providers (bringing unique expertise in innovative service delivery approaches). On the other hand, we have the public sector—which sets the social goals and has the capacity to develop an overarching coordination framework. An independent evaluator usually measures the impact of the project according to predetermined outcome metrics. Co-production with service users, families, and voluntary carers is also encouraged. For these reasons, the SIB model can bring about the paradigmatic shift from New Public Management toward New Public Governance and Public Value, whereby the creation of public value founds its practice on dialogue, exchange, and co-creation among relevant interest groups. The fundamental underpinning mechanism of SIBs relies upon the measurement of social outcomes and the generation of cashable savings as a result
of improved outcomes (e.g. lower recidivism rates will accrue savings in police, courts, prison, probation, etc.). Ideally, the savings in public service budgets are used to fund the repayment of the intervention plus the financial return to private investors. Experiences, such as the Rikers Island SIB (see Box 6.1), demonstrate that, regardless, the fundamental condition to pay the private counterpart is the achievement of the social outcomes. This mechanism has been regarded as a way to improve performance management and measurement in social service delivery, introduce greater efficiency and accountability for authorities and service providers, and increase innovation and personalization of services. However, this mechanism has raised some concerns on the viability of SIBs. On one hand, establishing a direct causal link between an intervention and its outcome is generally complex but, on the other hand, cashable savings may be difficult to estimate at the outset as they are usually achieved in the long term and results may not be clearly attributable to one single authority’s budget. However, what is appreciable is the will of private investors to take the risk of making their return conditional upon a third party’s ability to reach social outcomes.

Public-private-plural partnerships such as SIBs—as per Henry Minzberg’s definition—could represent the right vehicle both to capture
the increasing social awareness of private investors and to support the public sector to achieve higher effectiveness and equity in its action, together with increased efficiency and accountability.

6.2 SIBs’ Features Emerging from International Experiences

After the first SIB was launched in 2010, the number of deals has grown consistently, with the majority of projects concentrated in the past few years. Such initiatives were mainly developed in Europe and North America. The highest number of SIBs is found in the UK, where their implementation has been policy-driven (top-down approach). Leveraging the money coming from the Big Lottery Fund, the government set up seven investment funds with a total of £191 million in funding,² which commissioning authorities can use—upon application—for SIB outcome payments. SIBs are also used in the US, Australia, and Canada, as well as in continental European countries such as Portugal and the Netherlands. In the latter countries, SIBs have been mainly developed through a bottom-up approach, that is, promoted by private partners (mainly philanthropic investors such as foundations and charities).

In Europe, SIBs have been used to tackle social problems in the area of workforce development, particularly focusing on youth and refugee unemployment, and homelessness, with projects mainly focusing on housing as well as support provision to vulnerable people. By contrast, in the US, they have been applied in the area of criminal justice, to reduce prisoners’ recidivism. In some cases, the services conceived within the SIBs can be considered innovative (i.e. programs based on a new configuration, approach, therapy, etc.), while in other cases, they are based on an expansion of existing practices (i.e. programs already tested scaled up and applied to other target beneficiaries). The unmet social issues that SIBs have addressed so far were either already covered by existing, though ineffective, public services, or uncovered. In the former case, the CA has a budget that can be used to pay the investors and a baseline of current costs to estimate potential savings. In the latter case, no budget is available and, therefore, extra resources have to be budgeted in to cover SIB outcome payments.

² https://www.gov.uk/guidance/social-impact-bonds.
So far, SIBs have an average duration of up to four or five years. This rather short length is due to the small size of the upfront investment. Actually, the financial value of implemented SIBs has been, on average, €3 million, but 50% of projects have a budget of less than €1.5 million. This confirms that SIBs are low capital-intensive—as they focus on service, instead of infrastructure provision—and so far, they have been mainly applied on small-scale initiatives.

In terms of financial structure, despite the name and as previously explained, SIBs are not bond-like instruments, but they have been mainly funded through private debt and equity. The type of security used and, in many cases, the issue of a guarantee (provided either by public authorities or private philanthropic investors) have significantly affected the risk profile of SIBs. The UK-based SIBs have been generally structured as equity investments since they are based on ad hoc funds, while in the US and Continental Europe, debt-like structures secured through a guarantee are more common. The drawdown of the upfront capital and the payment of the outcome fee have followed different structures and schedules, according to the timing of the activities and the outcome measurement, thereby affecting also the return earned by private investors.

The return profile has been quite variable and, in many cases, undisclosed. In case the social outcome is achieved, the outcome payment has been set, on average, at 190% compared to the initial investment, within a range that goes from 100% (i.e. just capital reimbursement) to 500% (i.e. a payment five times greater than the investment). In case of underperformance, in some projects the payment has been reduced to zero, while, in other projects, a guarantee was provided, in order to cover up to 95% of the initial investment. Furthermore, in terms of IRR, implemented SIBs have targeted, on average, a 5.20% on an annual basis, within a range that goes from 1% to 12%. In most cases, if the social outcome achieved is above the target, the actual IRR is higher than the target IRR, but a maximum IRR (i.e. a cap) is defined.

3 If the service is delivered to more than one cohort of beneficiaries over a period of more than one year, payments have been usually made in multiple tranches. If no intermediate output is set and it is expected that results are achieved and measured at the end, or even after the end, of the intervention, the repayment has been made in one single tranche at the maturity.
SIB contracts involve, as a rule, the following categories of investors:

1. Foundations, charitable organizations, and religious institutions: they represent the majority of SIB investors.
2. Impact investors: impact investing firms are specialized asset managers with the mandate to commit capital to enterprises and projects that pursue both social and financial returns. They represent the second largest group of investors in SIBs.
3. Mainstream investors: banks and traditional financial intermediaries are only involved in a few SIB projects. They commit money within their CSR policies or, when protected by guarantees, within their standard asset management portfolios; the latter case is often a way to provide alternative investment opportunities to their high net worth individual investors.

In the majority of cases, foundations and impact investing firms have acted as hands-on investors, meaning that they have played as originator of the SIB as well as anchor investor (i.e. they have conceived and designed the project and looked for other investors). Impact investing firms are a perfect fit for SIBs. In the majority of cases, these investors manage dedicated SIB funds, which are invested on a commercial basis with clear target financial IRR. Foundations, given their concerted focus on addressing key social challenges and their willingness to invest on a non-repayable basis, have not invested in SIB on a commercial basis; in some cases, they have not only provided the funding to cover part of the cost of the intervention, but also provided a guarantee to reduce other investors’ capital losses. When guarantees are provided by philanthropic organizations, as in the case of the Rikers Island SIB (see Box 6.1), they have stimulated mainstream investors to experiment with SIB investments, which otherwise would not have been possible given the lower risk appetite of this type of investor. Other relevant constraints, such as SIB small average deals’ size and the difficult fit of SIBs within their usual asset allocation framework, prevent many mainstream investors from allocating capital to these instruments.

So far, investors in SIBs have been mainly foundations, motivated by testing out the instrument rather than setting optimal contractual and financial incentives. As a consequence, as discussed above, the return profile of SIBs is quite variable and there is no evidence on how these returns have been calculated. In many cases, foundations have acted as
intermediary organizations, facilitating the selection of the most appropriate, efficient, and effective service provider. In other cases, the intermediary has been a specialized organization or an SPV (i.e. special purpose vehicle, a specific legal entity created ad hoc to implement the project). In some cases, service providers were the SPV’s shareholders, even though, in most cases, they have generally acted as mere sub-contractors.

Although so far, SIBs developed across the world show certain common elements (i.e. payment conditional on target outcomes, impact measurement, involvement of a plurality of public and private stakeholders), at the same time, there is considerable variety in the way these initiatives have been initiated and structured. This is clearly evidenced when considering, for example, project’s promoters, level of innovation of the intervention, financial structure and return, type of investor involved. Box 6.1 highlights the differences between two cases of implemented SIBs.

### 6.3 Some Critical Reflections on SIBs

The main rationale for introducing SIBs is the need to improve outcome delivery through innovation in the provision of social services provision. However, international experiences show that the majority of SIBs are based on already implemented and well-established models delivered by service providers with proven track records (Vecchi and Casalini 2019). One possible explanation for this trend could be that investors motivated by a return on investment have little incentive to fund risky innovative experiments. Some argue that SIBs merely represent the continuation of the effort of successive UK governments to reduce direct public intervention in social services whilst simultaneously encouraging increased investment from the private sector and marketing for the third sector. Since social innovation is risky, it should imply a strategic role of the government, even through forms of financial support or risk sharing, which is exactly the opposite of a SIB model that is based on a complete risks’ transfer to the private sector. Actually, evidence from past international SIBs shows that, in many cases, private investors do not bear the risk of achieving the social outcomes since commissioning public authorities or, more frequently, philanthropic investors (such as foundations) provide guarantees to cover up to 95% of capital losses. Despite the risk of adverse selection and moral hazard when guarantees are used (as discussed in Chap. 2), well-designed guarantees may be important to mitigate the risks associated with innovative experiments and sustain the attraction of private capital into SIBs, especially in their early phases of development.
Box 6.1 A comparison of two SIB experiences

In this box, two cases of SIBs are discussed. The first was implemented in Birmingham (UK) in the sector of youth homelessness and unemployment, the second on Rikers Island (NY, US), in the field of criminal justice. The Birmingham SIB follows the UK standard model; it was commissioned following a top-down approach, the scope of the intervention can be regarded as innovative and the financial structure consists of an unsecured equity investment. By contrast, the Rikers Island SIB is an example of a bottom-up approach, consisting in the expansion of existing interventions and presenting a debt-like financial structure secured through a guarantee provided by a philanthropic investor. While the Birmingham SIB was funded by Bridges Ventures, the largest impact investing firm worldwide, the Rikers Island SIB received money from Goldman Sachs, one of the biggest American investment banks.

**Birmingham SIB**

This SIB was commissioned by the UK Department for Communities and Local Government (DCLG) and the Cabinet Office as part of the Fair Chance Fund. Focused on Birmingham, Coventry, Walsall, and Solihull, its aim was to support around 300 of the most vulnerable young people into accommodation, education, training, and employment. Social Finance acted as the intermediary company, while the non-profit organization, St. Basils, delivered the service. A pool of impact investors provided the upfront capital to cover the cost of the intervention. This SIB reached its end on 31 December 2017. Outcomes were particularly strong compared to targets, with 102 young people entering full- or part-time employment against a target of 75, and 290 young people entering stable accommodation, against a target of 250.

**Program**: The Rewriting Futures program supported 300 young people aged 18–24. The program consisted in providing a housing solution as well as innovative personal coaching, thereby featuring a relevant and supportive link into education, employment, and the community.

**Target outcomes**: Out of the 300 young people targeted, the program aimed to support at least 250 into accommodation, 200 into education, and 75 into sustained employment. Measurement of results was made quarterly.

**Financial structure**: Bridges Ventures, Big Issue Invest, CAF Venturesome, Barrow Cadbury Trust, and The Key Fund provided £1 million equity to fund the intervention. In the event of success, the maximum aggregate payment made by the DCLG to investors would have been £2.5 million.

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*Sources: [http://www.bridgesfundmanagement.com/portfolio/st-basils/](http://www.bridgesfundmanagement.com/portfolio/st-basils/), [https://www.socialfinance.org.uk/projects/fair-chance-fund--st-basils](https://www.socialfinance.org.uk/projects/fair-chance-fund--st-basils), [https://www.gov.uk/government/news/23-million-to-help-homeless-turn-around-their-lives](https://www.gov.uk/government/news/23-million-to-help-homeless-turn-around-their-lives).*

(continued)
Another key rationale behind SIBs is that, within incentive-based contracts, private stakeholders would be able to generate higher social outcomes than the public sector alone. This would result in reduced costs for the public sector and increased value for society. The underpinning mechanism of SIBs relies upon the realization of savings for the public sector, as a result of improved outcomes, which ultimately would be used to deliver a higher financial return to private investors. International experiences show that a value for money (VfM) analysis has usually been carried out in order to assess the desirability of a SIB and to quantify the expected savings for the CA. While traditional VfM applied to PPP typically focuses solely on the financial costs (risk-adjusted) of the different investment

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**Box 6.1 (continued)**

**Rikers Island SIB**

The project launched in 2012 to support the delivery of therapeutic services to 16- to 18-year-olds incarcerated on Rikers Island was the first SIB implemented in the US. It represented a partnership between the City of New York (commissioning authority), the Department of Correction (paying authority), Bloomberg Philanthropies (the foundation promoting the project, which provided a guarantee to reduce the risk borne by private investors), Goldman Sachs (private investor), MDRC (intermediary), the Osborne Association, and Friends of Island Academy (non-profit service providers).

In 2015, the Vera Institute of Justice (independent evaluator) concluded that the intervention had failed to reduce the recidivism rate as targeted. The initiative was, therefore, discontinued and no payments were made to Goldman Sachs, thus triggering the guarantee provided by Bloomberg Philanthropies.

**Program:** The Adolescent Behavioral Learning Experience (ABLE) program involved 4458 young men aged 16–18 entering the NYC jail on Rikers Island and at risk of reoffending. The ABLE program was designed following the Moral Reconciliation Therapy, developed in 1985 and widely used in prisons, jails, residential juvenile facilities, drug courts, probation programs, and schools.

**Target outcomes:** Recidivism rate within the treated group of people was expected to fall at least by 10% compared to the historical group. This would have generated a maximum of $20 million long-term savings for the City of New York.

**Financial structure:** Goldman Sachs provided a $9.6 million loan to fund the intervention. Bloomberg Philanthropies guaranteed $7.2 million of this investment. In the event of success, the payment made by the Department of Correction to Goldman Sachs would have been $11.7 million, equal to a 5.1% IRR.

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5 Sources: www.nyc.gov/html/om/pdf/2012/sib_fact_sheet.pdf, https://www.frbsf.org/community-development/files/rikers-island-first-social-impact-bond-united-states.pdf.
options (see Chap. 8), VfM methodology, when applied to SIBs, represents a first attempt to go beyond the mere financial value and quantify, in monetary terms, the impact of improved outcomes. However, it must be noticed that, so far, the focus has been much more on the realization of savings in the public budget as a result of improved outcomes, rather than on the improved outcomes themselves (e.g. savings in police, courts, prison, probation, etc., due to lower recidivism rates, rather than the value of lower recidivism rates for society). This approach could induce governments and service providers to prefer more standard programs, which may generate short-term savings but have limited long-term social impact. The short-term perspective may also be preferred by investors because results are easier to quantify, and the risk of default is lower.

6.4 CAN SIBS’ EXPERIENCE AND PHILOSOPHY BE APPLIED TO TRADITIONAL PPP CONTRACTS?

Despite the different nuances, SIBs could be regarded as a first step to testing the feasibility of linking the investors’ payment to social outcomes and, therefore, as a scheme that could be extended back to infrastructure-based PPP contracts, in a sort of virtual circle reasoning, since we have argued that SIBs originated from PPPs. This calls into question whether a “SIB-like” PPP could be an appropriate solution to attract more private investors able to provide financial resources in order to close the infrastructure gap by focusing on projects that maximize public value.

Past international SIBs show that, although they have been developed in a “protected” environment, thanks to the commitment and financial support of philanthropic organizations, the model has been generally applied to small-scale projects, at local level, with limited risk transfer to financial investors and little innovative scope. Drawing on this evidence, we may deduce that the amount of money requested to develop hard infrastructure, the long-term perspective to generate social results, the risk-adverse profile of long-term investors generally involved in such projects, and their preference for standardized solutions could make the application of the SIB model to infrastructure-based PPP harder. Furthermore, to make the SIB model applicable to infrastructure projects—especially in the social field—and to reach more challenging social outcomes, EOs should be involved in the delivery of core services. However, this is not always possible because such services usually remain the exclusive responsibility of the public sector, at least in mature economies. Moreover, while a social outcome can only be reached through a
service (which cannot be limited to building and adequately maintaining a facility), it is clear that linking financial return to social outcomes (which is the essence of SIBs) without involving the private partner in the delivery of the service would be impossible. Since PPP has generated a lot of criticism among politicians and public opinion, especially in mature economies, it may be difficult to extend the experiment of the SIB model to social infrastructure if one of the prerequisites thereof is the extension of the contract scope to core services. Perhaps small-scale PPP initiatives, in specialized sectors such as that of medical equipment, could draw some features from the SIB experience. In fact, it has been observed that some industrial investors may be willing to accept being paid on the basis of the health-value achieved (Porter 2009). In emerging countries, SIBs could be suitable for the implementation of more complex infrastructure investments, also in the framework of blended finance mechanisms offered by supranational organizations. The social challenges raised by Covid-19 pandemic will certainly spur new needs, which public authorities may be able to satisfy through engaging in social innovation and new approaches to public-private collaboration. Box 6.2 includes some considerations, under a legal perspective, on how to extend SIB rationale to PPP contracts, to generate a new form of outcome-based PPPs.

**Box 6.2 SIB-like PPPs from a legal perspective**

The distinctive feature of SIBs—or outcome-based contracts—is the assumption of risks linked to the outcome of the project involved. This additional risk could be qualified as a more advanced form of the operating risk, which needs to be transferred in concession/PPP models (as explained in Chap. 3). From a legal point of view, therefore, SIBs could be included within the open category of PPP contracts. However, outcome risk goes beyond what is generally accepted by private partners in PPPs as a typical contract obligation, based on the achievement of the agreed level of performance. Moreover, in classic SIB models, such risk is not borne directly by EOs performing the contract (receiving the agreed payment for the services rendered), but is borne by the investor, who, paradoxically, is not involved in any direct contract activity.

Therefore, although, it is conceivable for SIB models to be applied to PPP contracts, it is, however, necessary to carefully adapt the classical SIB schemes. First of all, the sectors in which they can be applied

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6 The box is written by Velia M. Leone.
must be adequately selected. Social services—also known as “services of general interest” within the meaning of the EU legal framework—can either have an economic nature (SGEI) or be based on pure solidarity principles, therefore, being fully paid by the public sector through general taxation (SGI). SGIs do not allow for the transfer of operating risk. In fact, where SGIs are outsourced, they are usually entrusted to non-profit operators through traditional procurement contracts. An accurate choice of the sector involved is therefore fundamental in order to avoid entering into invalid contracts.

Moreover, PPP contracts cannot be based on unrealistic or poorly constructed outcomes that cannot reasonably be forecasted with a sufficient level of accuracy and, therefore, cannot be factored into the economic and financial planning of any EO. Economic and financial balance is a pre-requisite for entering into a PPP contract. However, in highly regulated sectors or areas, for instance, in the public healthcare sector, the expected outcomes may be determined by a series of factors beyond the competence and reach of the service provider. Therefore, in such cases it is not appropriate to transfer an outcome risk that the EO cannot estimate, nor manage.

Furthermore, engaging in SIB-like PPPs requires a very careful identification of both the scope of contract—in terms of output—and the value outcome to reach. The latter could be set in terms of savings or invariance of public expenditure, or, more realistically, of concrete advantages (quantifiable according to clear and objective criteria) for service users or targets. In a view to designing an appropriate risk balance, it is necessary to identify a system of indicators and parameters suitable for detecting the actual achievement of the expected results and, at the same time, appropriately monitoring their progress, during contract execution.

In practice, in order to apply SIB-like models to PPP contracts, the remuneration system should be adjusted, so as to provide for a first level of payment, linked to performance (in the classic PPP sense) and a second level of payment, conditional upon achieving the desired outcome. In this way, traditional operating risk would apply to PPPs’ typical—or even challenging—output requirements, while reaching further outcomes would trigger additional rewards. This methodology necessarily internalizes a certain flexibility, during the execution of the contract, further incentivizing EOs. Such flexibility is allowed, under EU legal frameworks, provided it is appropriately regulated within the contract from the outset (see Chap. 3 for further reference on contract flexibility clauses).
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