Social Impact Bonds and Government Contracting

How to Choose the Best External Organization to Achieve Your Outcome

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Social Impact Bonds, or SIB, are an innovative new tool that flips government financing on its head. They allow agencies to pay only for measurable, positive social outcomes after achievement rather than paying upfront for a set of activities. This tool will likely prove challenging for many in government, from program designers who are not used to defining measurable outcomes to politicians who like making decisions about which interventions will be used to tackle social problems.

But it will be contracting officers who face a real Catch-22: In a SIB agreement the external organization has significant latitude to change its work plan midstream if the interventions it has chosen are not working. Inevitably, however, SIB contracts will be awarded partly on the basis of the proposed plan's strength. So the contracting agency faces the problem of how to choose the external organization best able to achieve the outcome when their ultimate means to the end may be very different from their original plans. (Broadly, we think that SIB partners should be allowed to deploy any strategy that does not cause harm or increase costs for government, citizens, or business.)

Before awarding a contract, government agencies should be clear about the outcome they want achieved and the most they are willing to pay for that outcome. Sometimes, agencies will have a budget that they will want to maintain.

For instance, in the recidivism example (box), the government will pay the external organization once they reach a certain threshold of achievement—a 10 percent reduction in the re-offending rate. But the external organization may be able to do even better and reduce recidivism by 20 or 30 percent—in which case they will expect higher remuneration. So if the government agency has a budget constraint, it should indicate that during the process of selecting an external organization. Otherwise potential partners may develop plans that are too ambitious.

How Social Impact Bonds work

Social Impact Bonds are relatively straightforward. In a SIB agreement, a government agency decides on an outcome it wants achieved—say, reducing juvenile recidivism in an area by 10 percent—and contracts an external organization that promises to achieve the outcome. The external organization is free to develop and implement its own strategy. If the external organization succeeds, the government pays them a sum of money that may be based on the expected savings to government from achieving the outcome. If the external organization fails, the government pays nothing.

Ultimately, government agencies want to partner with an external organization that will successfully deliver the outcome. As we explain below, agencies should evaluate bids from external organizations using three key sets of criteria: the quality of the organization's plans for achieving the outcome; the overall quality and demonstrated abilities of the organization itself; and the price government will pay the organization if it achieves the outcomes.

Confidence in plans

Although the government should not require the external organization to use a particular intervention to achieve a Social Impact Bond's outcome, the external organization's bid should still contain a work plan. The plan should:

- **Describe the interventions that will be used—and why.** The government will cede control over day-to-day activities to the external organization, but the external organization needs to demonstrate that they have thought seriously about how to achieve the outcome. To that end contracting officers should want at least some of the organization's planned interventions to have rigorous evidence of effectiveness in similar circumstances. If there is any data available on what external factors make the intervention more likely to succeed, the external organization should seek to demonstrate those factors will hold true in their plan.

- **Describe a back-up plan.** Since the external organization is allowed to change its tactics midway through the SIB agreement, contracting officers should expect the organization to have plans in place to respond to and replace unsuccessful interventions.

Confidence in the external organization

The government shouldn't just evaluate the external organization's plans when awarding a Social Impact Bond agreement. Because of the trust inherent in these unusual arrangements, the government agency will want a high degree of confidence that they will be able to form a cooperative working relationship with an external organization capable of carrying through the plans. To gain confidence, the agency should consider:

- **Management.** The government will need to work with the external organization regularly to, among other things, provide access to data and to the population of beneficiaries. Having confidence in the external organization's senior employees is essential as the government and the external organization will need to work closely together throughout the agreement.

- **Track record.** The government should also consider the organization's track record—whether they have successfully contracted with the government before, whether they are able to manage complex projects, and whether the service providers they plan to use have strong histories of success.

- **Working capital.** Although the government agency should not expect to approve or vet the external organization's investors—who will provide working capital to run the interventions—the external organization should provide strong evidence that they understand how much money is needed to fund the interventions and demonstrate they will be able to raise the necessary funds. This is important to assure the government agency that the Social Impact Bond agreement will get off the ground.

Cost considerations

While government should not pry into the external organization's cost structure, it must consider the price it needs to pay for outcomes.

For instance, external organization A may bid for a SIB contract to reduce juvenile recidivism and ask for a $10 million payment, while external organization B asks for a $15 million payment for the same outcome. If the two bids are otherwise similar, particularly in providing evidence of effectiveness, and the government agency believes that either organization could be successful, it must choose the bid from organization A because of the lower cost.

Of course, things will often be more complicated than this. Government officials will sometimes find that the organizations they are most confident working with are also more expensive, and those that want less money have less convincing strategies for success. Procurement officials are used to making decisions that look at quality and cost considerations alongside each other and Social Impact Bonds are no different to other contracting arrangements in this regard.

Conclusion

During the contracting process for a Social Impact Bond agreement, government agencies will need to ask questions about the external organization's strategy and ensure that the organization is strong enough to achieve the outcome.

But the biggest challenges will crop up after the ink has dried. Because, with few exceptions, that's when the government will have to let go and allow the external organization to change its work plan, raise money from any investors it wishes, and do what it can to achieve the outcome. Few government agencies will be used to providing that level of freedom to external partners.

Our next column in this series will focus on the Social Impact Bond agreement itself and lay out the provisions that should (and should not) be included. A concurrent issue brief will offer answers to many technical questions about the SIB contract, including the circumstances under which an agreement can be terminated and what kinds of protections are needed to ensure the safety of the beneficiary population.

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