

DO THE BENEFITS OUTWEIGH THE COSTS OF IMPACT BONDS?



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Acknowledgements

The authors would like to thank a number of individuals who provided invaluable edits and insights on this brief: Alison Bukhari, Jared Lee, Andrew Levitt, Mila Lukic, Tamar Manuelyan Atinc, Ana Mazon, Peter Nicholas, Ariella Rotenberg, Kate Sturla, and Maya Ziswiler. Outstanding design support was provided by Shavanthi Mendis and David Batcheck, and Katherine Portnoy provided excellent editorial support.

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Brookings gratefully acknowledges the support provided by the UBS Optimus Foundation and the British Asian Trust. Brookings recognizes that the value it provides is in its commitment to quality, independence, and impact. Activities supported by its donors reflect this commitment.

Overview

To conclude this series of policy briefs, this fifth brief considers perhaps the most critical question to evaluate the success of impact bonds: whether, given costs and benefits, impact bonds are an efficient and cost-effective way to contract and finance the delivery of social services. Since very little concrete data is available on costs and benefits in impact bonds compared to alternative financing mechanisms, the brief explores a set of theoretical assumptions and a thorough analysis of potential costs and benefits to provide a more nuanced analysis than has been in the literature to date. The brief also identifies four ways to potentially lower the design and implementation costs of impact bonds, as well as makes the case for future research.

More and better outcomes

While progress has been made in addressing some of the world's most difficult social issues—for instance, under-5 mortality has more than halved over the past three decades—still, in 2019, over 5 million children died from mostly preventable and treatable causes (WHO, 2020). Such failure to ensure the well-being of millions of citizens across the globe has caused policymakers and funders to seek alternative forms of tackling these intractable challenges. One proposed solution has been to change the funding mechanism to deliver those critical social services. Results-based financing (RBF) was designed to extenuate the problems of misaligned incentives that arise when contracting services through traditional input-based financing. This so-called principal-agent problem stems from the lack of incentive structure ensuring performance from a service provider (the agent), since the provider will be paid by the principal for services (as inputs or budget-based fixed payments, for example) regardless of the impact on beneficiaries (Savedoff, 2010; Ross, 1973). The assumption of RBF is that tying payments to results generates an incentive for the party receiving the contingent payment to ensure results are achieved, thereby alleviating the principal-agent incentive problem.

Impact bonds are a new form of RBF, however, notably, since financial or operational risk is shifted away from the service provider (and government) to an investor (often an impact investor), the principal-agent problem remains. So, what mechanisms are present in impact bonds that give rise to the expectation that they will generate more and better outcomes than both input-based financing and traditional RBF? How do these mechanisms relate to costs? And, do impact bonds have benefits other than beneficiary outcomes that should be considered in the trade-off with costs? The next section explores the range of potential impact bond benefits, and the sections following examine the costs that are incurred in impact bond design and implementation, and several ways that these costs could be reduced.

Measuring the benefits of impact bonds

The benefit of an RBF program, as outlined above, is the increased likelihood to achieve results (outputs or outcomes). The third brief in this series is dedicated to this question of whether outcomes have been achieved through impact bond interventions. However, while outcome achievement is one potential benefit of impact bonds, in particular when compared to costs, it may be appropriate to consider a more nuanced perspective of the potential benefits of this mechanism. This can be summarized as the **three E's**:

1. **Effectiveness**, or ability to achieve outcomes;
2. **Economic returns** (personal and social); and
3. **Ecosystem effects**.

1. Effectiveness, or ability to achieve outcomes

While historically there has not been a great deal of attention placed on the relationship between public spending and measurable results, increasingly, this is changing as social challenges persist and as budgets are more constrained (which is likely to be heightened by the COVID-19 pandemic). The last two decades have seen a rise in impact measurement, including a movement around rigorous impact evaluation in development aid, as well as in OECD countries.¹ The key questions policymakers and funders have sought to understand through impact evaluations are whether one intervention is better than another in achieving outcomes, if one intervention with some variation is better than no variation, or even whether an intervention is better than doing nothing at all.

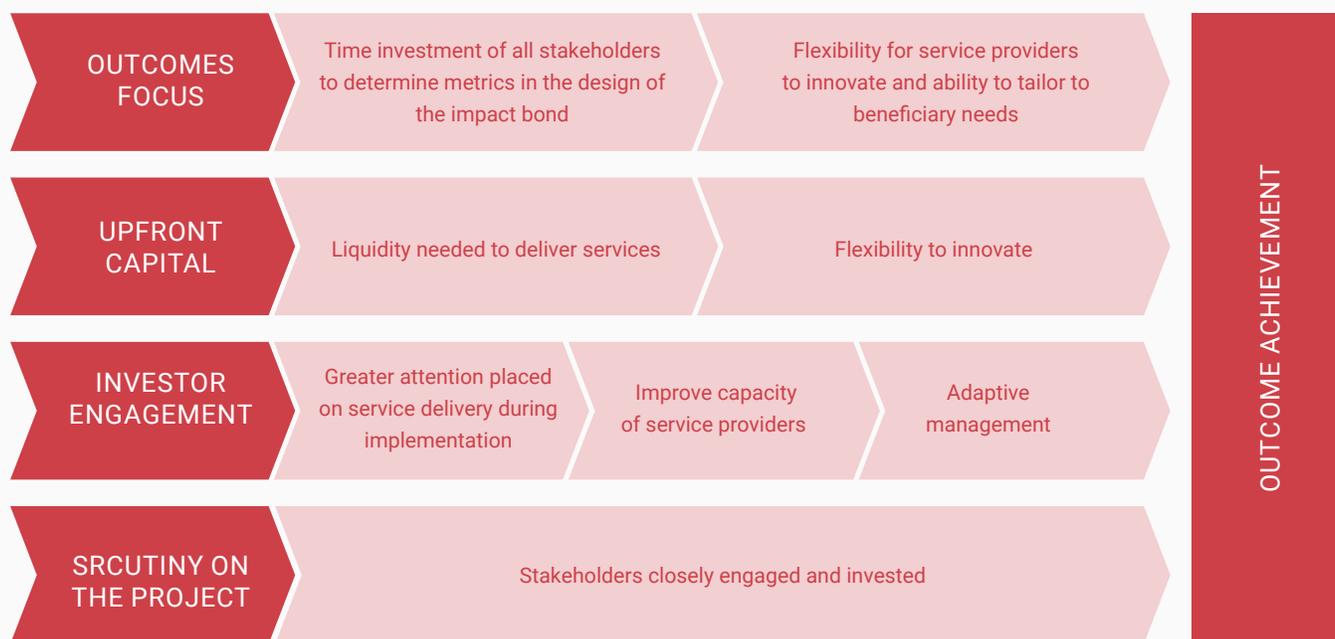
¹ In the developing world, this has been largely sparked by applied development economics and randomized controlled trials (RCTs), such as those out of J-PAL at MIT and SIEF at the World Bank. This was codified in the 2005 Paris Declaration on Aid Effectiveness and the 20018 Accra Agenda for Action (Grittner, 2013).

When it comes to impact bonds, a key question is whether, for a given intervention, they are in fact more effective in achieving outcomes than other financing mechanisms. As noted above, RBF mechanisms are designed to create an incentive for the agent (service provider) to deliver results. However, although impact bonds are a form of RBF, the pathway to results is different. Figure 1 below lays out several hypotheses underlying a plausible theory of change for why impact bonds might lead to improved outcomes achievement. First, often the metrics selected for payment in impact bonds are farther out in the results chain, or more closely related to impact (outcomes). This requires both an investment of all stakeholders to determine metrics in the design of the impact bond and later gives service providers the flexibility to adapt and tailor services to beneficiary needs. Second, funding for service delivery is often provided upfront or in tranches, giving service providers the liquidity to deliver services and the ability to innovate. Third, the involvement of the investor can bring scrutiny to service delivery during the implementation of the project, as well as capacity building around performance management. Finally, the novelty of the approach (still, ten years into their use) brings increased political and media attention to the projects, which can generate additional reputational risk incentives to ensure outcomes are delivered.

When it comes to impact bonds, a key question is whether, for a given intervention, they are in fact more effective in achieving outcomes than other financing mechanisms.

However, the above outlined theory of change is based on a set of hypotheses. In order to truly answer the effectiveness question, a rigorous impact evaluation (experimental or quasi-experimental) is needed to compare the same intervention financed through two different approaches: impact bonds versus alternative forms of financing. As explained in the third brief in this series, such evaluations have yet to

Figure 1: Impact bonds theory of change



Source: Author's elaboration

be conducted for impact bonds. Even the literature on the effectiveness of traditional RBF is limited, mixed, and varies across the different types of RBF mechanisms and intervention types. This is visible even within a single sector: A 2016 report (Burnett & Jayaram) for the Global Partnership on Output-Based Aid analyzed 24 education sector outcome-based aid (OBA)² projects and found that the tool was most effective in specific education subsectors (early childhood, vocational, and higher education), with specific stakeholders and incentive structures. In the health sector, a comprehensive study of RBF finds that while there is suggestive evidence of improved healthcare supply and outcomes, a lack of rigorous, controlled experimentation means that it is difficult to attribute outcomes to the RBF mechanism itself (Grittner, 2013).

² Results for Development (2016) define OBA as "a form of results-based financing in which service providers are contracted to improve education access and/or quality, especially for disadvantaged populations, whereby service providers assume some degree of performance risk for specific outputs/outcomes upon which payments are contingent."

A separate issue that should be considered is that a potential limitation to fully and rigorously capturing the effectiveness of impact bonds is that often impact bonds focus on and measure only a few specific metrics for the repayment agreement. This narrow focus could possibly result in an evaluation not being designed to capture the full impact of a program's range of outcomes. As noted in one report, "Using a single outcome to define success may miss a range of other benefits that might result from the program—benefits that also have real value but will go unmeasured" (Berlin, 2016). Conversely, there is a risk that through measuring specific outcomes, there is also a potential to focus resources only on these measured outcomes, and to miss or underfund many of the other elements that would improve the lives of the beneficiary population.

2. Economic returns (personal and social)

The achievement of outcomes for beneficiaries can lead to further benefits—beyond their intrinsic value—for those individuals and their surrounding society, which are known as economic returns. Economic returns can be measured in terms of both private and social benefits, but often the public sector is primarily concerned with the latter. In the education sector, for example, the private benefit of an additional year of schooling is the increase in earnings for the rest of the individual's life, which is estimated at about 5-8 percent per year (Patrinos, 2016). The social benefit, on the other hand, is comprised of the societal gains resulting from additional schooling, including, for example, greater social cohesion or spillover effects of more educated individuals interacting with each other.

Since economic returns are the result of outcome achievement, the now familiar challenge of attribution emerges: It is not possible to attribute economic returns to the impact bond mechanism itself without counterfactual data. There is a different argument that is often used, however, with respect to impact bonds: Relative to standard government grant funding, impact bonds focus more on interventions that prevent some negative and thereby costly outcome in the future—both for the individual and for society. For example, a project focused on reducing prison recidivism by providing services to individuals who are incarcerated can have positive impacts on participants, but also will save the government money in the long run by avoiding the costs of their re-incarceration. Early on, in fact, many social impact bonds (SIBs) were focused on calculating direct cost savings to government entities, primarily through avoiding social services costs for program participants. As Berlin (2016) notes, “By design, nearly all of the early SIBs were premised on government-budget savings. Indeed, in those deals, payments to investors depended on those savings.” While preventative impact bond interventions undoubtedly have positive impacts on individuals, they also have broader social benefits and expenditure

implications for the government. Though governments value both fiscal and non-fiscal benefits, it is the fiscal benefits that are often used to make a case for bureaucratic efficiency.

The argument could be made that some interventions supported by impact bonds indeed have the potential to produce government savings, but is it true that they are overall focused on the most preventive interventions? While many do, as a whole, impact bonds certainly are not the most preventive, from a lifecycle perspective. Evidence shows that the earlier an intervention reaches an individual, the sooner the life trajectory of that individual can be improved, and thus the greater compounded potential benefits (Gertler et al., 2014; Heckman, 2006). However, as described in the second brief of this series, the majority of impact bonds focus on adults, rather than on young children, thereby missing the beneficiary population with the potential for the greatest benefits, and thus the largest cost of inaction.

There are some further challenges with focusing on budgetary savings. First, quantifying them can be very challenging, and the further the time of the intervention is from the time of the avoided negative outcome, the more difficult it can be to model. This is particularly difficult in cases involving young children, in which, as mentioned, the benefits will stack over many years, and will become more and more difficult to quantify over time. Second, in developing country contexts where remedial interventions or social welfare is limited or non-existent, there may not be a great deal of direct budgetary savings. Third, this premise can distract from the very real challenges in social services delivery and the need for systems that improve the lives of beneficiary populations, regardless of future budgetary impacts (Golden et al., 2017).

While preventative impact bond interventions undoubtedly have positive impacts on individuals, they also have broader social benefits and expenditure implications for the government.

3. Ecosystem effects

In addition to the potential for the achievement of more and better outcomes and the personal and economic benefits resulting therefrom, there are several other ecosystem-level benefits that impact bonds may bring, as explored in depth in the fourth brief of this series. These include, for example, innovation in service delivery, improved systems of monitoring and evaluation and performance management capacity, and an increase in collaboration between stakeholders. Perhaps the largest ecosystem effect of impact bonds is the outcomes-focus. By emphasizing outcomes, rather than inputs, impact bonds and other forms of RBF have played a large role in the social service sectors' shift toward outcomes as a whole, even in more traditional forms of financing. This is not to say that all of these elements are exclusive to impact bonds; in fact, some may come about regardless of the form of financing, but anecdotal evidence does suggest that the structure of the impact bond is a strong driver of these benefits.

Perhaps the largest ecosystem effect of impact bonds is the outcomes-focus.

A good example encompassing several ecosystem effects comes from the Quality Education India (QEI) development impact bond (DIB), which targets more than 200,000 primary school-aged children in four states in India and has explicitly stated its intentions to create ecosystem-level change. In addition to improved learning outcomes for children, the QEI DIB seeks to gain insights about the effectiveness of different interventions for possible future scale, as well as to provide capacity development and improvement for service providers and other education stakeholders (Dalberg, 2020).

Another ecosystem effect not previously mentioned has been a demonstration to governments and donors of the need for a certain type of service, whether or not that expanded service is provided through impact bonds. The Peterborough SIB is a good example of this, in which “It was identified that unresolved mental health issues had a statistically significant and substantive impact on the cohort’s reoffending behaviour,” a realization which led to the government commissioning additional complementary mental health interventions for the population served by the impact bond (Center for Global Development, n.d.). In an example from the United States, in the state of Utah, an impact bond led to legislation for improving the quality of preschool education and expanding access to early childhood education programs across the state (Utah Department of Workforce Services, 2019).

Box 1:

Impact bond benefits key takeaways

- The outcomes focus, upfront capital investment, investor engagement, and attention on the project, are, in theory, the main pathways to better and greater outcomes in impact bonds.
- The benefits of impact bonds are not limited to the achievement of outcomes, but also include economic benefits and ecosystem benefits.
- Rigorous research on the range of benefits in impact bonds compared to other forms of financing is needed.

Measuring the costs of impact bonds

One of the most common critiques of impact bonds is that they are too expensive to design and implement. In many cases, it is true that the cost of impact bonds has been high, in particular among the earliest impact bonds. When examining the issue of cost, however, it is important to consider what is included in the total cost of structuring, implementing, and validating an impact bond project, and how this compares to other forms of project financing. It is also important to take into consideration how the impact bond market has evolved over time with respect to costs and how these costs have been and can be reduced further.

Table 1 outlines the different cost categories, activities within those categories, and how these costs differ across impact bonds, traditional RBF, and input-based financing. As evidenced in the table, many of the costs that occur in impact bonds also occur in other forms of project financing, though they may not be incurred in the same way, by the same actors, or—in particular—at the same level. Each of the three broad cost categories are explored in more detail below.

It is important to consider what is included in the total cost of structuring, implementing, and validating an impact bond project, and how this compares to other forms of project financing.

Table 1: Costs of impact bonds compared to other forms of financing

Cost categories	Activities	Cost present in...		
		Impact bonds?	Traditional RBF?	Input-based financing?
Project design and structuring	Feasibility study	✓	◆	◆
	Capital raising	✓	✗	✗
	Determination of intervention and outcome metrics	✓	✓	✓
	Due diligence of service providers	✓	✓	✓
	Procurement of service providers	✓	✓	✓
	Financial structuring	✓	✓	✓
	Contracting/legal services	✓	✓	✓
Project implementation and oversight	Identification of beneficiaries	✓	✓	✓
	Delivery of services	✓	✓	✓
	Monitoring/performance management	✓	✓	✓
	Performance management support to service provider	✓	◆	◆
	Stakeholder collaboration	✓	✓	✓
	Communications/public relations	✓	◆	◆
Verification/evaluation and cost of capital	Evaluation Design	✓	✓	◆
	Evaluation Implementation	✓	✓	◆
	Investor returns	◆	✗	✗
	Capital borrowing costs	✗	◆	◆

✓ = Yes ✗ = No ◆ = Sometimes

Source: Author elaboration.

Project design and structuring costs

One of the costliest elements of impact bonds is often the deal design and development process. “Transaction costs” is the term most often used to refer to deal structuring and design, including but not limited to, capital raising, due diligence, determination of metrics, financial structuring, and contracting. These components often require specific expertise, including past experience structuring impact bonds, sectoral and measurement know-how, and legal expertise. This knowledge often cannot be found in-house, and thus requires service providers, investors, and outcome funders to bring in external parties such as intermediaries, legal counsel, and technical assistance. Hence, while in the table above it appears that many of the specific activities in this cost category are present in other forms of contracting, interviews with impact bond stakeholders have revealed that they have been higher in many contracted impact bonds to date. Some impact bonds have taken several years to contract, for example, requiring significant resources from all parties involved. Adding to the costs has been the resources necessary to educate stakeholders given the novelty of the impact bond instrument itself, which despite 10 years of use, is still often little understood by many of the players on both the public and private side of the negotiations.

As Elyse Sainty, who has contributed to the structuring of at least five impact bonds in her role at Social Ventures Australia (SVA), notes that impact bonds are “resource-intensive (for all parties), with transaction overheads that are disproportionate to the benefits being generated” (Sainty, 2019b). With the level of scrutiny placed on the expenditure of public funds, in particular those that involve a “return” to private investors, the outcomes funders are especially interested in ensuring that the outcomes measurements and dispute mechanisms are clear so that returns are not paid if outcomes are not achieved. In cases where the risk involved with the investment is for private funds (sometimes representing retirement accounts and savings), private investors are

concerned with a different, and somewhat competing, set of risks aimed at maximizing return potential and rate. These competing interests must be navigated and negotiated, often involving the use of an intermediary organization with experience in the impact bond space.

However, it is important to note that development and transaction costs are certainly not zero in any other social service provision. Responsible public procurement requires significant due diligence, including legal and compliance costs, as well as a thoroughly structured contract. However, because other forms of financing have been around longer and are more common, governments and service providers using these other forms of financing have more standardized processes and procedures, which decreases some of the costs involved. Several of these elements are beginning to emerge within the impact bond space, as covered in more detail later in this brief.

It is also worth considering whether the time spent on project design, and thereby the transaction costs, could have an impact on the results or benefits of a project. While the deliberation processes that bring all parties together at the beginning of an impact bond to negotiate the outcomes, metrics, etc. may be costly, they can also yield great benefits. These processes allow for all parties involved to develop a much stronger understanding of the problem itself, and to design solutions. As Educate Girls stated “Deep thinking about delivery, target setting, measurement etc. is appropriate for solving complex problems” (A. Bukhari, personal communication, July 2020). Other forms of project financing, which may skip some of these processes, may base decisions on assumptions rather than full consideration of the problem.

“Deep thinking about delivery, target setting, measurement etc. is appropriate for solving complex problems.”

Project implementation and oversight costs

Impact bonds generally support the provision of social services (with only a handful of impact bonds in the environment or agriculture sectors), which are often provided by nonprofit organizations. When it comes to cost, it is possible that service delivery costs more when there is an outcome focus for two reasons. One reason is that greater resources may be necessary to achieve outcomes than to track input and activity-driven contracting—the frequency or dosage of an outcome-focused intervention may need to be higher than to deliver inputs or outputs. In an education results-based program, for instance, it would likely be more costly to improve a child’s learning outcomes than to get that same child to attend school. Second, it may be necessary to collect more and better data about service provision and results to make decisions about resource allocation. In the example above, it is also more costly to monitor and evaluate complex learning outcomes than binary ongoing attendance tracking. These implementation, monitoring, and evaluation costs are generally borne mostly by service providers who are likely to build them into the project costs at the beginning of the negotiation process in an impact bond.

In addition to service provider costs for monitoring, evaluation, and performance management, there may be external costs in an impact bond associated with intermediaries or investors who work closely with service providers. There may also be greater human resources dedicated to coordination of the project. Stakeholders from impact bonds often cite the time dedicated to communication—emails, calls, and in-person meetings with the consortium of stakeholders. Finally, the high profile of impact bonds has often required additional resources dedicated to external communications and public relations.

While the cost of impact bond projects has been cited by many service providers to be higher than similar projects funded through another mechanism, this is not always the case, and may differ by stakeholder.

For example, in a 2020 report, Bridges Fund Management (Bridges) compares public rates for U.K. government-funded programs to rates in which the government actually paid for similar impact bond projects, and finds that, on aggregate the government paid less for outcomes under impact bond projects (Bridges, 2020). Proponents of impact bonds claim that cost savings emerge due to program adaptability and innovation, as service providers and investors can find “new ways to deliver better outcomes at lower cost” (Bridges Fund Management, 2016). This can often be attributed to technical assistance to the service provider organizations by private sector stakeholders—often the investors or intermediary organizations. The Innovation Fund evaluation reported that both intermediaries and investors contributed performance management expertise, allowing providers to focus on service delivery. Investors were also reported to have “hands-on” roles in project management, and scrutinized service delivery (Thomas et al., 2016). Another example is, broadly speaking, technical assistance given to service providers adopting and utilizing data-driven monitoring systems.

Bridges highlights this reality by noting that some commissioners of services (outcome payers) will not pay any more per beneficiary for a service than has been paid in the past, regardless of additional benefits the program may bring. This leads Bridges and other stakeholders to work with service partners to find innovative delivery and service opportunities to provide cost savings, which can cover investor returns, and the transaction costs associated. This role of providing cost savings, which Bridges frames as “hands-on management support (either directly or via specialist advisors)” for providers and “helping to build their organisational capacity” (Bridges, 2016), is not very common across the global impact bonds market.

Verification/evaluation costs and cost of capital

The third category of costs, including evaluation costs and investor returns, are often the most scrutinized. It is therefore important to consider each of these in depth.

Verification/evaluation costs

Evaluation costs are another element that can be high in impact bond projects, as well as in other outcomes-based-financing. This is because impact bonds rely on the premise of being sure that the outcomes contracted have been achieved in the targeted beneficiary population. However, it is important to note that traditional RBF and input-based financing may also use evaluations to measure and verify results.

As outlined in the third brief of this series, there are different levels of rigor when it comes to measuring outcomes and evaluating the extent to which the outcomes observed can be attributed to the intervention itself, and, generally, increasing levels of rigor are associated with higher costs. Overall, however, very few (five of 49) completed impact bonds thus far used rigorous impact evaluations such as experimental (RCTs) or quasi-experimental designs.

However, some high-profile impact bonds have used these more rigorous methods, likely leading to the myth that all impact bonds have expensive (and rigorous) evaluations. As noted in the second brief, most impact bonds are rather small and serve a median of 500 individuals, while many evaluation costs are fixed, resulting in a high relative cost (Sturla et al., 2018). A famous example is the Educate Girls project, in which the RCT cost around a quarter of a million dollars, and total project costs came to around \$1 million (Saldinger, 2018). While this is certainly a high price tag to pay relative to the impact bond investment, it also brought with it an extremely high level of validity, and this proof of concept allowed Educate Girls to use this as evidence to seek additional funding from new sources to scale up. In a later impact

bond, the Village Enterprise DIB, which is considerably larger than the Educate Girls DIB at a total budget of \$5.26 million, the evaluation cost was similar to that of Educate Girls (with the same evaluator, IDinsight); hence the evaluation-to-project ratio was much smaller (Sturla et al., 2018).

Most impact bonds are rather small and serve a median of 500 individuals, while many evaluation costs are fixed, resulting in a high relative cost.

Although there are ways to reduce rigorous evaluation costs such as through scale or using administrative data, in general they are often expensive. However, in addition to the proof-of-concept benefits noted above, experimental or quasi-experimental evaluations supply information on whether results could be attributed to the intervention used in the impact bond or some exogenous factor(s). This can provide protection for the stakeholders involved (investors and outcome funders in particular). The solution to the evaluation cost problem is not to skimp on the evaluation budget, but to consider what must be delivered in the specific situation, and to design around this. In some cases, the costs will be high, but they may be worth it.

Cost of capital

Likely the most common criticism of impact bonds is the potential for private earnings from public or philanthropic monies. However, it is important to remember that an investor return could also be considered the cost of a risk, and that risk exists regardless of the funding mechanism—the only question is who bears the financial or operational risk. Transferring this risk from governments or funders to investors implies a cost.

As Elyse Sainty of SVA outlines in her “letter from the field” (2019a), the financing element of impact bonds can be considered as two different financial services that service providers may require:

- **Bridging finance:** provided because outcome contracts do not make payments until after (sometimes well after) the costs of delivery are incurred
- **Insurance:** provided to protect against risk, in this case of a program not achieving the stated outcomes and therefore payment not being made

In both of the above financial services, it is reasonable that investors, as providers of these services, should be appropriately compensated. This payment, the “cost of capital,” is also the return paid on the investment in a successful impact bond project. In Australia, as in some other countries, much of investor capital is superannuation funds, or retirement funds of individuals, and as such trustees of these funds have a responsibility and fiduciary duty to ensure that investment returns are appropriate for the level of risks undertaken (Sainty, 2019a).

Impact bonds are often touted as a “win-win-win” structure, in which: 1) Governments receive risk-free funding for program implementation, often for new or more complex approaches; 2) Investors can receive repayment plus interest on shorter-term projects rather than longer-term traditional investment funds; and 3) Service providers receive upfront investment in programs, and potentially technical support and guidance from the investor and intermediary to serve more individuals (Berlin, 2016). However, in reality, each of these three “wins” can be losses. To illustrate this example, we can take a closer look at the ABLE project in New York. In this case, because the program did not achieve outcomes, the government did not pay for outcomes and the investors suffered a loss (see the third brief in this series for more details).

In the early years of impact bonds, their ability to incentivize an upfront investment in an intervention was a selling point and differentiated

them from traditional RBF contracting, where contract participation is most often pre-financed by service providers, with payment received only upon the achievement of results. This may exclude some smaller service providers from entering such contracts; a recent review of U.K. Department for International Development suppliers in the pre-financing stage found that 93 percent of the supplier organizations surveyed used their own funds to finance projects (Chinfatt & Carson, 2017). And furthermore, it is often much more difficult for smaller providers to borrow capital, which further places them at a disadvantage.

However, it is important to note that, on average, smaller service providers have not consistently engaged in impact bonds, owing to the primacy of perceived investment readiness (Edmiston & Nicholls, 2018). Researchers at the Urban Institute define this readiness as not simply an openness to an experimental model, but the ability to implement the project through consistent leadership, staff capacity, resources to scale, and data systems and processes in place to track inputs, outputs, and outcomes (Bieretz & Eldridge, 2019).

Box 2:

Impact bond costs key takeaways

- Many cost elements that are present in impact bonds are also present in other forms of financing, but costs tend to be more explicit in impact bonds which can make it seem that the costs are always higher.
- Design, structuring, and oversight costs can be higher in many impact bonds due to the novelty of the mechanism, the complexity of the contractual structure, and the need for all parties to agree on metrics, measurement, and payments.
- The size of an impact bond project is an important factor for relative costs.
- Risk transfer comes at a cost—in impact bonds, this is the return paid to investors.

Four ways to lower the cost of impact bonds

As impact bonds become more well-known and widely used, many believe that their development process is becoming less burdensome, and that transaction time and costs are declining (Sainty, 2019a). However, this is not always the case, and many recent impact bonds have still taken years to contract. Brookings research has identified four clear ways to potentially lower the costs of designing and implementing impact bonds, some of which are already taking place.



1. Build knowledge and generate champions

As noted above, one of the most resource intensive aspects of impact bonds is the initial groundwork to get them started. This is in part due to the novelty and lack of understanding of the mechanism: In particular, knowledge is low among outcome funders, especially governments. Once up and running, it is necessary to keep momentum going, which requires political backing and dedicated champions within institutions. One way to reduce these startup costs is to have access to common shared resources including, for example, simple explanations for how the mechanism works so this is not developed on a bespoke basis. Some academic and think tank examples of these types of resources include the Brookings impact bonds research and database, the Government Outcomes Lab at the Blavatnik School of Government, the Government Performance Lab at the Harvard Kennedy School, and the Pay for Success Initiative at the Urban Institute. Other government- or donor-led initiatives include, for example, the U.K. Centre for SIBs, Portugal Inovação Social, and the Impact Bonds Working Group, which brings together members (mostly donor agencies) to build the impact bonds market in developing countries. Investments in these types of

platforms and resources generate important public goods that have the potential to lower transaction costs and provide important learnings so that impact bonds and other forms of outcomes-based financing can continually be improved over time.



2. Pool investment capital

Another area in which to potentially improve efficiency and effectiveness is around the raising and management of investment capital. Historically, many projects have raised the investment capital they need directly from asset owners. However, it has generally not been possible to raise this capital until the project has been sufficiently well-developed, with clearly articulated estimates of the risk profile and the amount of capital likely to be required. Dedicated funds, with a small, active “fund management” team, can improve market efficiency. Such pooled investment funds have already taken off in the U.K., such that the majority of impact bond investing is now via dedicated “social investment funds,” and they are starting to gain traction in the U.S., albeit in small numbers relative to the entire size of the impact bond market.

In 2008, the U.K. Cabinet Office chose to catalyze a dedicated social investment fund to provide risk capital for outcomes contracts and to social enterprises directly. The Cabinet Office provided seed funding of £3.5 million of investment and selected a manager, Bridges, to run it with a mandate to raise at least matching capital. This process led to the launch of the £12.5 million Social Entrepreneur’s Fund in 2009. This Fund invested into 4 of the first SIBs in the U.K. and made a range of other investments into social enterprises. In 2012, Big Society Capital (BSC) catalyzed a new investment fund specifically to provide risk capital for payment by results contracts. BSC allocated a seed investment of £10 million, and again mandated that the selected manager must raise at least matching capital. This process led to the creation of the £22.5 million Social Results Fund (name later changed to the Social Impact Bond Fund following discussions with the Cabinet Office). It

has now been deployed, and Bridges is managing a successor fund, the £35 million “Social Outcomes Fund II,” again with BSC as a cornerstone investor. BSC has simultaneously catalyzed the creation of a wide range of dedicated social investment funds, which have the mandate to provide risk capital for payment by results contracts, among other things (M. Lukic, personal communication, September 2020).

In the United States, Maycomb Capital established the Community Outcomes Fund (not to be confused with concept of outcomes funds in the following section), raising over US\$40 million from a dozen investors (as well as a 20 percent first-loss guarantee) to invest in human services in low-income communities (A. Rotenberg, personal communication, September 2020).

A new project on the horizon is a partnership between the UBS Optimus Foundation and Bridges aimed at being the first global fund to invest in impact bonds and outcomes-based mechanisms. The aim is to raise USD 100 million (with up to 20 percent first-loss guarantee), corresponding to total outcome funds of USD 250+ million focused on Sustainable Development Goals 1, 3, 4, 8, 13, 14, and 15 with a focus on South Asia and Africa (M. Lukic, personal communication, September 2020).



3. Create outcomes funds

Outcomes funds, also born in the U.K., are one of the key possible cost reduction tools for impact bonds. Outcomes funds can pool several different impact bond agreements through streamlined and shared contract templates, metrics, and evaluation systems. This process allows for lower transaction costs as they are spread across a wider number of and larger projects, as well as more standardized metrics and benefits across a range of different project interventions or geographies (GPRBA, 2019). In theory, outcomes funds can also lead to projects launching in less time through standardizing contracting

processes. Also, the outcomes fund model can spread the risk to the investor across a portfolio of projects and/or outcomes.

By far the largest number of outcome funds have been launched in the United Kingdom; the first, launched in 2012, was the Innovation Fund, a 30 million-pound pilot program for employment and education outcomes for young people aged 14 and over. This was followed by additional funds targeting employment (Youth Engagement Fund and Life Chances Fund), as well as other sectors such as homelessness (Fair Chance Fund and DCLG Rough Sleeping SIB Fund). In addition, the Social Outcomes Fund and Commissioning Better Outcomes Fund seek to grow the SIB market as a whole (Gustafsson-Wright et al., 2017).

An example from the developing world is the Education Outcomes Fund (EOF), which recently launched calls for proposals for its first two programs that will strengthen education systems in Ghana and Sierra Leone. These programs will together reach approximately 1,100 primary schools, split into 11 contractual “lots” of roughly 100 schools each, significantly lowering the transaction costs per contract. A total of \$45 million in outcomes funding is being committed to these programs by their respective governments and other donors. In the initial responses to the call for proposals, a mix of private investors, foundations, and implementers put forward over \$50 million in private finance to cover the upfront implementation costs. As a hosted trust fund at UNICEF, EOF has also established standardized outcomes contracts, drawing on both U.K. outcomes contracts and DIBs around the world, aiming to move toward standardized contract terms that balance the needs of all parties. In Ghana, donor funds are being managed by GPRBA at the World Bank, with the outcomes contracts issued by the government of Ghana. In Sierra Leone, contractual arrangements were not finalized at the time of publication of this brief.

In Colombia, the world’s first SIB in a developing country gave way to a second, both of which are in the employment sector. Many of the same actors in these two SIBs are now working to develop an outcomes fund,

building on their knowledge from the first two SIBs, which is already reducing costs in many ways. The Colombia team notes that without the investments in the two earlier impact bonds, the outcomes fund would not have been possible.

Other sector- or population-specific outcomes funds are in the pipeline across the globe, including for education, nutrition, diabetes, and hypertension.



4. Streamline technical assistance needs

As described in the measuring costs section, another costly component of impact bonds has been the expertise needed to design, structure, and contract the projects. In most impact bonds thus far, this expertise has not been present among the service providers, investors, and outcomes funders and has required outside expertise, most often in the form of an intermediary.

In particular, the intermediary role is often questioned in terms of the added project costs. It is important to note that this “intermediary” term is one with many different definitions and covers many different roles in impact bonds, and these different roles should be broken down when considering potential cost reductions. In the very early years of impact bonds, intermediaries were key in championing the mechanism, and they also added technical expertise in design and execution. This model has been particularly prominent in the United States, where intermediaries have played an important role in developing the impact bond market. Another role that an intermediary can play is that of a “fund manager,” as Bridges in the U.K. plays, in raising the capital and advising on the program design. A third key role that intermediaries play is technical assistance to service providers, most often in performance management.

There are several ways that intermediary and technical assistance costs can be reduced. One is that as expertise becomes institutionalized within governments, service providers, and investors, the need for intermediary organizations is reduced. Another way is to base new projects on earlier project structures, including by using previous contract templates or by creating standardized contracts. For example, in the U.K., Bridges noted that the family therapy impact bonds contracting process has gone from taking one to two years when starting from scratch, to contracting several similar programs in different areas in a much shorter time period. Bridges notes that much of their success has come from gradually learning through experience how to set up a contract which incentivizes all parties, at all levels of the project. The contract is how they reliably structure “collaborative, flexible, relationship-based delivery,” as opposed to more top-down approaches to social service delivery. A third way to reduce costs is to develop common sets of metrics by sector or issue area for given geographies. One example of this, and using earlier contract structures in the previous point, is the provision of standardized contracts and metrics as part of the Social Impact Bond Knowledge Box at the UK Centre for Social Impact Bonds, which supports SIB development in the U.K. (U.K. Government, n.d.). Finally, standardization of pricing outcomes would greatly benefit cost reduction in impact bond development. The challenge with this is that, as with metrics, pricing is very context specific, making it hard to standardize. An alternative way to identify the appropriate price per outcome is through outcome funds described above.

Consistent across qualitative evaluations of impact bonds thus far has been the time and cost-intensive need for intermediary support to service providers and government agencies. Yet, these evaluations have also noted that investment in intermediaries has generally led to improved data collection, performance management, and collaboration. Identifying which are the critical pieces that need to be outsourced will be helpful in reducing impact bond costs in the future.

Comparing costs to benefits

After an examination of a decade's worth of impact bond projects across the globe, the short answer to the question of this brief—"do the benefits of impact bonds outweigh the costs?"—is that there is no rigorous evidence thus far to answer this question. This gap in evidence is due to the lack of both publicly available data on costs, and rigorous analyses of benefits relative to alternative financing mechanisms, thereby preventing a comparison of the two. Notably, comparative data also remain sparse on costs and benefits for other forms of RBF, which have a much longer history, as well as for examinations of more traditional forms of financing. Until cost data is more widely and transparently available from impact bond stakeholders, and investments are made in rigorous evaluations of the mechanism, this question will remain difficult to answer.

We conclude that further research is necessary, and that this research should be much more nuanced than has been seen in mainstream discourse on the topic to date. It should carefully consider the full slate of both costs and benefits of impact bonds, as outlined in this brief, and compare these to alternative forms of financing. For the first category of benefits, outcome achievement, this would entail a cost-effectiveness analysis (Shepard et al., 2015). Such an analysis, requiring both cost and impact evaluation data, would yield the cost per outcome achieved in a project funded by impact bonds and compare this to the cost per outcome of a project funded under an alternative mechanism. Another way to examine if benefits outweigh the costs of impact bonds would be through a cost-benefit analysis which compares the second category of benefits, economic benefits, to costs and again compares all this information to an alternative form of financing. This type of analysis may be hampered however, as mentioned above, by the difficulty in monetizing benefits, in particular social benefits. The third category of benefits, the ecosystem effects (improvements to

data and performance management systems, increased collaboration among stakeholders, and adaptive delivery innovations) are the most difficult to quantify, as their impact is, by definition, dispersed across the ecosystem. Furthermore, monetizing this impact is challenging. Quantifying the costs of these elements and comparing them to projects with similar elements would be a contribution, however.

We conclude that further research is necessary, and that this research should be much more nuanced than has been seen in mainstream discourse on the topic to date.

In summary, although there is still a lack of critical, rigorous evidence on the efficiency of impact bonds, the anecdotal evidence on their benefits—in particular the ways in which they seem to be changing the landscape of social services, as seen earlier in this series—elicits hope that progress is being made. It should be recognized, as noted at the top of this brief, that much of the status quo has not yielded desired outcomes for all. We are at a critical inflection point: Do we forge forward with old ways of doing things, or do we continue to build the plane as we are flying it, with the goal of reaching higher heights? We are hopeful that the next 10 years will lead to more clarity on these questions of where, when, and for whom impact bonds or other forms of outcome-based financing are an effective and efficient way to achieve positive outcomes.

Box 3:

Implications of COVID-19 for the benefits and costs of impact bonds

In early 2020, the virus causing COVID-19 began to spread across the globe, leading governments to put in place measures to ensure the health and well-being of the populations they serve. While, at the time of this publication, the long-term impacts of the pandemic on the economy are only being modeled, the short-term effects are already devastating. Mandated stay-at-home orders and business closures have led to unprecedented disruptions in economic activity and dramatic shifts in the delivery of critical social services around the world.

Brookings has conducted some initial analysis³ on the effects of the pandemic on the services delivered through impact bonds, as well as the effects of the crisis on various components of the impact bond model. Capturing learnings for the management of ongoing impact bonds (144 serving 1.2 million individuals in the first quarter of 2020), as well as for the design of future impact bonds, will be critical to ensure effective and efficient service delivery in the future.

COVID-19 relief measures have been extremely costly, and when the world begins to emerge from this crisis, it will be saddled with social and economic challenges of an immense scale—and particularly for cash-strapped and risk-averse governments. Since, in an impact bond, a private investor provides upfront financing which is only repaid (with returns) if the program is successful, the tool represents an innovative bridge financing opportunity to inject new, private funds into public service financing in a time of crisis. Most impact bond contracts are at least three to five years long, providing governments or other entities a runway before making any payments, and then, only if the intervention has delivered results. Furthermore, as impact bonds are used to finance social services such as employment and job training (or retraining), homelessness, education, and more, they have the potential to contribute directly to economic recovery. This would also put governments in a better position to have more funding available when the time for repayment comes around.

³ <https://www.brookings.edu/research/what-happens-in-an-outcome-based-financing-model-when-a-major-crisis-hits/>

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