Department of Legislative Services

Maryland General Assembly
2013 Session

FISCAL AND POLICY NOTE

Senate Bill 434 (Senator Ferguson, *et al.*)
Budget and Taxation and Education, Health, and Environmental Affairs

State Board of Education - Social Impact Bonds - Request for Proposals

This bill requires the State Board of Education to issue a request for proposals (RFP) for Social Impact Bonds (SIBs) to improve education for children in the State, prekindergarten through grade 12, by January 1, 2014. The State Board of Education may issue additional RFPs for SIBs, as needed and may contract with entities to implement one or more SIBs. The bill also establishes minimum proposal guidelines and project selection guidelines. By September 1, 2015, and annually thereafter, the State Board of Education must report on the results of the issued SIBs.

The bill takes effect July 1, 2013.

Fiscal Summary

State Effect: General fund expenditures may increase by $700,000 to $4 million from FY 2014 to 2018 depending on whether an investor is willing to invest in a SIB and whether the performance outcomes are met. Since SIBs are a new concept, it is assumed that the State will at least initially have to provide upfront funding for some or all of the SIB contract costs.

Local Effect: Potential impact on a local school system that is granted a SIB contract with the State Board of Education. Potential increase in revenues and expenditures, and a risk of not recouping expenditures if performance measures are not met.

Small Business Effect: Potential impact on nonprofits that are granted SIB contracts with the State Board of Education. Potential increase in revenues and expenditures, and a risk of not recouping expenditures if performance measures are not met.

Analysis

Bill Summary: A "social impact bond" is defined as a contract between the State and a private or nonprofit organization in which the organization provides upfront funding for a project aimed at a particular social objective, with repayment and interest contingent on achievement of specified social outcomes and financial savings to the State.

Current Law: SIBs have not been authorized in Maryland.

Background: SIBs represent a relatively new concept for financing and contracting for the delivery of social service programs. They are designed with the intention of shifting the financial risk of performance-based payments from providers onto investors. This allows governments to, in theory, increase the portion of funding linked to the achievement of an outcome without damaging the funding of service providers.

In many respects SIBs are misnamed because actual bonds are not typically issued; the government contracts with investors, a program manager, and nonprofit service providers for a SIB program. If an independent evaluator finds that the SIB program produced outcomes equal to or greater than the targeted levels, then the government reimburses the investors for their capital, along with a return on investment. In the event that the program does not produce the targeted outcomes, then the investors receive no compensation from the government and lose their capital investment.

Unlike conventional government social programs which tend to be prescriptive – governments contracting for specific services to be provided – in the SIB model, government defines the desired outcome(s) and the SIB issuer is responsible for selecting the programs or services that will be used to achieve the desired result(s). Because payment is dependent on achieving specific outcomes, SIB issuers have a vested interest in constantly evaluating the effectiveness of the programs and services being utilized and making adjustments as necessary to improve performance.

Under a traditional performance-based contract, providers, especially smaller community based nonprofits, can have solvency challenges associated with unpredictable cash flows. If 20% of normal contract funding is based on an outcome that is not achieved, this may cripple the operational funding of the nonprofit. The design of a SIB is intended to remedy this problem by providing the upfront working capital to service providers from external investors. Thus, if an outcome is not achieved, it is the investors who lose money, not the service providers. This allows jurisdictions, at least in theory, to increase the portion of funding linked to the achievement of an outcome without damaging the solvency of service providers.

Analysis of SIBs

However, there are no tangible examples of significant risk shifting occurring in practice for SIBs. There are two primary obstacles to shifting risk. First there must be an investment market with a tolerance for a high degree of risk in the outcomes of social programs. Second, the contract design must provide an enforcement mechanism to prevent investors and providers from terminating the contract early.

In addition, in practice, the SIB model increases budgetary pressure compared to direct financing, due to the necessity of funding contingent liabilities and the added expenditures of features unique to SIBs, such as program evaluations. Even a successful social program will likely be unable to self-finance within a reasonable timeframe; thus, governments will likely need to make the full payment necessary to fund the program and pay investors their return on investment. The government, therefore, realizes no upfront savings to finance the program and is still limited by current operating budget constraints.

SIBs were issued for the first time in the United Kingdom in 2010, to finance a program designed to reduce the prisoner recidivism rate. Initial results for the program will not be available until 2014, but the idea has already garnered attention in the United States. The federal government and the states of Connecticut, Massachusetts and New York, as well as Cuyahoga County, Ohio, and Fresno, California, are all introducing or exploring SIBs for projects ranging from housing the chronically homeless to reducing asthma-related emergencies.

The details of how SIBs will operate in practice are still being explored. In many programs, governments will use the anticipated savings from successful outcomes to fund the eventual payment to the external organization; an arrangement that assumes that a successful outcome will reduce government spending at least by the amount that will be paid to the external organization. The Massachusetts legislation established a fund to hold outcome payments for the duration of a social impact bond deal; and the contracts will be backed by the full faith and credit of the state. The arrangement in New York City is more complicated, as an investor is providing the working capital for the project to the service provider organization and the investment is partially backed by a philanthropic angel investor.

During the 2012 interim, the Department of Legislative Services (DLS) conducted a concurrent review of the feasibility, potential benefits, and risks associated with using SIBs to finance reentry programs; the Department of Public Safety and Correctional Services response to the recommendation mirrors the DLS analysis. A copy of the DLS analysis can be found at http://mgaleg.maryland.gov/Pubs/BudgetFiscal/2013-Evaluating-Social-Impact-Bonds.pdf. The DLS analysis concludes that using SIBs to reduce recidivism in State prisons is not cost effective.

The DLS analysis also concludes that the use of SIBs would also likely increase the cost of providing social services during the development and implementation of the SIB programs. This is due to the multi-year development phase necessary to create contracts linked to evaluations and the necessity of budgeting for contingent payments associated with both the cost of the program operations and a return on investment to outside funders.

Social impact bonds in policy areas outside of prisoner recidivism are likely to be more expensive for the State, according to the DLS analysis, because the marginal cost savings for avoided re-imprisonment are generally higher than the cost savings for other social service programs typically associated with SIBs.

State Fiscal Effect: Educating preK-12 students has societal value, as is demonstrated by the costs to society incurred by children that drop out of high school. Children that drop out of high school can result in greater dependency on public assistance among dropouts and high incarceration costs for the population. Students that drop out also face lower wages, which results in less future income tax revenue for the State. However, due to the long-term nature of the societal benefits and the numerous variables involved, it will be practically impossible to self-finance SIBs to improve education.

Since SIBs are relatively new and there is no market for them, it is assumed that the State will need to fund any SIB program upfront, as has been done for the SIB programs in the United Kingdom and Massachusetts.

For illustrative purposes only, general fund expenditures will increase by an estimated $4.0 million from fiscal 2014 through 2018 in the event that the performance measures are met. If the performance measures are not met, assuming a pure SIB model, general fund expenditures increase by $700,000 over the five-year period to operate the SIB program because the investor/service provider would receive no compensation. Alternatively, following a modified SIB model with the State as the investor, if performance measures are not met, general fund expenditures increase by $3.7 million from fiscal 2014 through fiscal 2018 to operate the SIB program and cover the service provider's operating costs. The following information and assumptions were used in these estimates.

- It is assumed that the smallest SIB project that will attract investors and service providers (nonprofits or potentially a local school system) is $3.0 million.

- It is assumed that the return on investment (ROI) is budgeted at 10%, below the maximum 13% ROI amount used in the SIB pilot program in the United Kingdom.

- It is assumed that the SIB funds ($3.3 million) will be budgeted equally over the duration of the project. It is also assumed that it will take approximately 18 months after an RFP is issued to negotiate a contract for a SIB. Therefore, general fund expenditures increase by $1.1 million annually in fiscal 2016 through 2018. If the project is able to attract investors, and follow a pure SIB model, it is assumed that the funds will be held in a special fund until fiscal 2018. The State would need to budget the funds annually to reassure the investor, and to avoid a huge payment in the final year of the project. In the pure SIB scenario, if the service provider meets the performance measures, the full $3.3 million will be paid to the investors. If the service provider is unable to meet the performance measures, then the State pays nothing and it is assumed the entire $3.3 million reverts to the general fund. In that case, the investor would lose its entire $3.0 million investment, which it had paid to cover the service provider's operating expenses. Potentially the service provider and the investor could somehow share the ROI funding in the event that the performance measures were met.

- Alternatively, if the State is unable to attract an investor due to the large risk and low ROI for the project, then potentially the State could be the investor and make periodic payments to the service provider to cover its operating expenses ($1.0 million annually beginning in fiscal 2016) and hold the ROI funding as a performance bonus ($100,000 annually beginning in fiscal 2016) in a special fund to be paid to the service provided in the event that the performance measures are achieved by fiscal 2018. In this scenario, if the performance measures were not met, than the State would not pay the service provider the performance bonus.

- Operating costs due to features unique to the SIB model are estimated to be $700,000 over five years. This includes $150,000 in program evaluation costs, $300,000 in contract design costs, and $250,000 in program management fees.

- The program evaluation costs are assumed to be at the lowest possible cost. Program evaluations frequently cost more than double the $150,000 budgeted in this scenario.

- The contract design cost was budgeted at $300,000. Each SIB contract is unique to the local program and jurisdiction. As such, each contract design will be expensive and time consuming. Maryland can expect a full design process to take approximately two years.

- The management fee to the intermediary is only large enough to pay for $50,000 per year in management fees at $250,000 over five years. An outside manager is a

key component to any SIB project and the Maryland State Board of Education does not have any experience with them.

This scenario is illustrated below in **Exhibit 1**.

Exhibit 1
Estimated Costs for a SIB Program
Fiscal 2014-2018

	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Direct Services			1,000,000	1,000,000	1,000,000
Return on Investment			100,000	100,000	100,000
Program Evaluation			150,000		
Contract Design		300,000			
Management Fee	50,000	50,000	50,000	50,000	50,000
Total	**$50,000**	**$350,000**	**$1,300,000**	**$1,150,000**	**$1,150,000**

Source: Department of Legislative Services

Additional Information

Prior Introductions: None.

Cross File: HB 517 (Delegate Rosenberg) - Ways and Means and Appropriations.

Information Source(s): State Board of Education, Department of Legislative Services

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