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Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programming in Maryland

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Executive Summary

Social impact bonds (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.

Although 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.

The Department of Legislative Services (DLS) has conducted a review of the feasibility, potential benefits, and risks associated with financing reentry programs using SIBs. Reentry programs are of particular interest to the Department of Public Safety and Correctional Services (DPSCS) based on its mission. Reentry programs are also generally considered a strong candidate for SIBs due to the potential for large cost savings to the government through the successful reduction of re-imprisonment. Based on the benefits commonly associated with SIBs, DLS evaluated the potential of SIBs to generate cost savings, help finance social programs, shift outcome risk, increase innovation in reentry programming, and build more rigorous evidence for policy decisions.

Even when using a set of highly optimistic assumptions, it is clear that pilot reentry programs cannot self-finance their operations. Because pilot programs cannot create a large enough reduction in demand to close a facility, the cost dynamics are driven by much smaller marginal cost savings. As a result, a program that produces a 10% reduction in recidivism for 250 prisoners per year over five years will only result in minimal avoided imprisonment costs. Before including the cost of direct services, the fixed costs of designing the contract, compensating a third-party intermediary, and conducting an independent evaluation, at $700,000 collectively, would alone exceed the fiscal benefits. Including service costs of $2,500 per participant, the program would result in a net fiscal impact of -$3.9 million. Doubling the size or assumed effectiveness of the program would not result in a positive net fiscal impact.

These results indicate that the additional costs of a SIB program cannot be justified by offsetting savings. Other potential benefits do not justify the cost or complexity of a SIB program either. Given the difficulty of linking the evaluation of a social program to a highly complex contract centered on an outcome payment, the government may actually increase its operational risks in undertaking a SIB. The government would also need to budget

upfront for the contingent liabilities of outcome payments. As a result, a SIB program would increase both budgetary pressure and operational risks.

Reentry programs can have great social value independent of their fiscal impact. The decision to finance them should be made independent of whether or not they can be self-financed through cost savings and a SIB mechanism. Because they are especially valuable and effective when integrated and combined with larger scale policies aimed at reducing recidivism and increasing public safety, DLS recommends that DPSCS continue to directly finance reentry programs while pursuing other organizational and policy changes likely to have greater impacts while posing less risk than a SIB financed program.

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Reasons for This Study

In the fiscal 2013 Overview of the Department of Public Safety and Correctional Services (DPSCS), the Department of Legislative Services (DLS) recommended that DPSCS begin examining the possibility of utilizing social impact bonds (SIB) by developing a request for information. In the interim, DLS has conducted a parallel review of the feasibility, potential benefits, and risks associated with financing reentry programs using SIBs.

The benefits commonly associated with SIBs are numerous. According to nonprofit organizations associated with their development, SIBs offer governments the ability to raise new revenue while shifting outcome risk for specific programs to the private sector. Under a SIB, the government contracts to reimburse investors only when positive outcomes are achieved. Payment amounts are based on the cost savings that the government realizes from the program. Because of the emphasis on outcome-based payments, SIBs help increase the rigor of evidence in policy decisions by requiring programs to be evaluated using advanced statistical methods.

These potential advantages are especially promising for reentry programming within DPSCS. Reentry programs can reduce the rate of recidivism, thereby reducing the long-term cost of incarceration. Beyond the potential cost savings, improving offender reentry into the community and reducing recidivism rates is a key part of the department's mission, especially as it moves forward with its reentry focused reorganization plan. However, past efforts to implement reentry programming in Maryland have not produced measurable improvements. Implementing a SIB, if feasible, could help stimulate innovation in programming while increasing the evidence base for future decisions.

This report evaluates whether SIBS can (1) generate cost savings; (2) help finance social programs; (3) shift outcome risk; (4) link payments to outcomes; (5) increase the rigor of evidence used in policy decisions; and (6) stimulate innovative solutions.

Following a brief introduction to the mechanics of SIBs, this funding option will be evaluated relative to each of these categories of potential benefits for a reentry program.

Background on Social Impact Bonds

How They Work

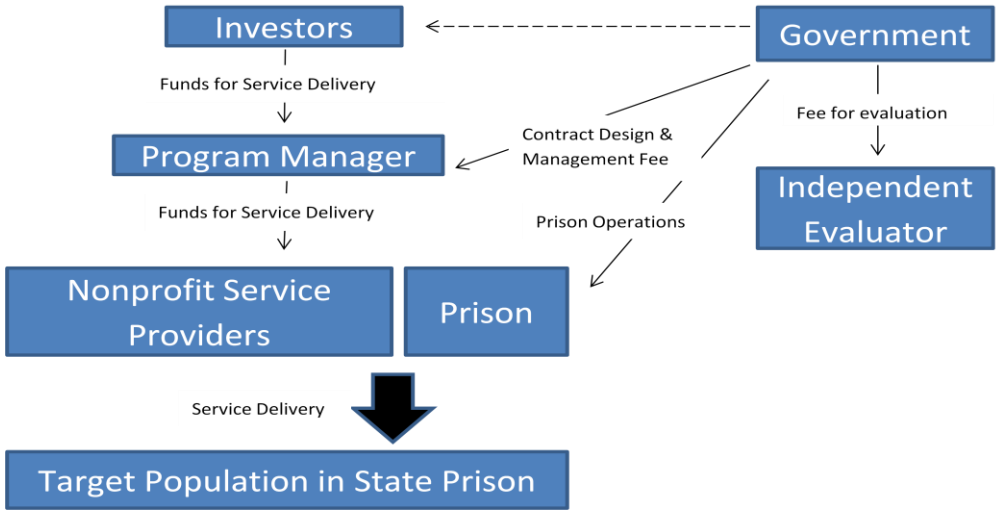
SIBs are a new form of a performance-based contract. Under more traditional forms of performance-based contracts, governments typically provide a fixed rate of reimbursement based

on the costs that contractors incur. In addition to this fixed rate, performance-based contracts include provisions for reimbursements based on some combination of quality and outcome measures.

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 to, at least in theory, increase the portion of funding linked to the achievement of an outcome without damaging the solvency of service providers.

Exhibit 1 shows the key parties and relationships for funding and service delivery in a SIB reentry model. Although actual bonds are not typically issued, the government contracts with investors, a program manager, and nonprofit service providers for a SIB program. Investors provide funding to the program manager. The program manager disburses funds to nonprofit partners who deliver the services. As services are delivered, an independent evaluator funded directly by government conducts a rigorous statistical program evaluation. If the 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 (ROI). 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.

Exhibit 1
Basic Illustration of a Social Impact Bond Reentry Model



Source: Department of Legislative Service

Regardless of the outcome, the government compensates the program manager and independent evaluator for the contract design, management fee, and independent evaluation. The government also operates the prison facility where the target population resides and the data systems used to conduct the evaluation. In Exhibit 1, the thin arrows represent funding flows, and the thick black arrow represents service delivery.

Under the traditional conception of a SIB, 100% of the payment is linked to the achievement of performance outcomes. In other conceptions, the risk incurred by investors can be decreased by tying less than 100% of the payment to an outcome. In all cases, the investors are compensated with a return on an investment that resembles the interest on a bond if the outcomes are achieved.

Peterborough Pilot Program

SIBs originated in the United Kingdom (U.K.) with a pilot program currently active in Peterborough. The program is intended to reduce one-year recidivism rates among short-term incarcerated offenders. Though SIBs are usually associated with payments linked to cost savings, payments are structured differently in Peterborough.

As one of the primary nonprofits associated with SIBs articulated, "SIBs… allow[] governments to transfer the financial risk of prevention programs to private investors based on the expectation of future recoverable savings."[1] However, in Peterborough, payments are based on an undisclosed, negotiated value that includes consideration for the cost savings to the government but was ultimately based on negotiations between the government and third parties, representing an acceptable level of return for the third party intermediary and investors. The payments were justified in terms of social value for the government "on the basis that the SIB was innovative."[2]

In the Peterborough pilot, the national U.K. government will reimburse investors if an independent assessor concludes that the program achieves a recidivism reduction of 7.5% or greater in the local prison. Returns to investors may be as high as 13.0% per year over an eight-year period, depending on the amount by which the program exceeds the 7.5% target.

Social Finance U.K. serves as the project manager and receives a management fee. Multiple nonprofit service providers, selected based on their reputation for high performance, operate in cooperation to provide reentry programming for prisoners leaving a single host prison. The U.K. government issued no actual bond. Instead, it contracts with the relevant parties. The complexity of these contracts is the primary reason why the project took two years to develop, a timeline consistent with experiences in Massachusetts, a state which has been developing a similar pilot program.

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[1] *A New Tool for Scaling Impact*, available at SocialFinanceUS.org.

[2] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, RAND Europe, 2011

Evaluating the Potential for Cost Savings

The majority of cost savings from a reentry program are associated with avoided reimprisonment. Within this category, the largest cost savings come when an agency can close a wing of a prison or an entire prison due to a drop in the number of prisoners. In Maryland, this typically requires a reduction of at least a few hundred prisoners per year. Until this threshold is obtained, DPSCS can only save on marginal costs for inmate wages, contractual services, materials, supplies, food, and medical costs. These marginal costs are approximately $4,623 per inmate per year for the department.

Statistics on recidivism and reimprisonment are not available for Maryland. **Exhibit 2** depicts the national trends for reimprisonment used for the financial models described below. Between 1994 and 1997, nationally, 5.0% of released prisoners returned to prison within six months. An additional 6.0% returned between six months and one year after release. In total, 27.0% of prisoners returned to prison within three years. This is based on a re-arrest rate for new crimes of 71.6% and a reconviction rate of 50.2% within three years of release from a state prison. The re-arrest and reconviction rates are two of the more common rates reported as the "recidivism rate" for jurisdictions. The reimprisonment rate is relevant to this analysis. A three-year, 27% rate of reimprisonment is broadly consistent with more recent studies conducted across a number of states by The Sentencing Project.[3]

Exhibit 2
National Reimprisonment Rate
Calendar 1994-1997

Time	Percent
6 months	5%
Up to 1 year	11%
Up to 2 years	20%
Up to 3 years	27%

Source: Bureau of Justice Statistics, Prisoner Recidivism Data Analysis Tool

Based on an extensive review of the research literature, highly effective programs can be expected to reduce the recidivism rate by a maximum of approximately 20.0%. Applying this 20.0% reduction in general recidivism to a three-year reimprisonment rate of approximately 27.0%, the total number of reimprisonments avoided as a result of a highly effective reentry program is proportionally a small reduction of 5.4% of the total number of inmates released

[3] *State Recidivism Studies*, 1995-2009

within the hypothetical reentry program. The cost savings for this 5.4% must therefore be equal to or exceed the cost of providing services to the 5.4% of participants avoiding reimprisonment and the remaining 94.6% of program participants.

Scenario One: 10% Recidivism Reduction

Using the national reimprisonment rates from Exhibit 2 and the marginal cost per inmate of $4,623 in Maryland, an optimistic model was constructed. It was assumed that prisoners served an average of three years after reimprisonment. The relationship between the program effect and the effects on the broader demand for prison beds was assumed to be equal. If, as a result of the program, 10 fewer individuals were reimprisoned each year, it was assumed that this directly resulted in a drop in demand of 10 beds per year.

The pilot program was also assumed to be effective with a reimprisonment reduction effect of 10%. This program effect of a 10% reduction in recidivism is in the upper range of effective programs. Many programs produce no measurable change in recidivism, and many successful programs produce a reduction smaller than 10%. To account for this fact, cost-benefit analysis in criminal justice commonly uses the average program effect, which would be even lower than the 10% used here.

The pilot program was assumed to have 250 participants per year. Realistically, operating a pilot program with this many participants may be difficult to achieve, considering this represents approximately 4% of total fiscal 2011 releases in Maryland. Reentry pilot programs, including some programs offered in Maryland, commonly aim for 250 total participants over the life of the pilot but often have difficulty achieving this much lower target.

Exhibit 3 depicts the number of prison beds saved by the Division of Correction per year under these assumptions and the associated cost savings. Over time, each operating year has a higher number of prison beds saved based on the cumulative effect of prisoners serving three-year terms (with staggered start times throughout each year). Although this program would be considered effective, it would result in a maximum of 19 saved prison beds in fiscal 2016 for a fiscal benefit of $89,571 in that year. The program would yield a total fiscal benefit of $247,908 in cost savings from avoided marginal costs over a five-year period.

Exhibit 3
Schedule of Benefits, Scenario One
Fiscal 2012- 2016

Year	No. of Program Participants	Returning to Prison Before Program Effect (No. of Persons)	Program Effect (No. of Persons Not Going to Prison) Current Year	Prison Beds Saved	Cost Savings
2012	250	27.5	-2.75	1	$6,357
2013	250	50.0	-5.00	5	24,271
2014	250	67.5	-6.75	11	51,431
2015	250	67.5	-6.75	17	76,280
2016	250	67.5	-6.75	19	89,571
Total	**1,250**	**280.0**	**-28.00**	**54**	**$247,908**

Source: Department of Legislative Services

Exhibit 4 details the costs of operating the program and reveals the total net fiscal impact after including the benefits from Exhibit 3. The cost of direct services was budgeted at $2,500 per participant. A cost per participant of $2,500 is on the lower end of the program cost spectrum but reflects the costs associated with a more intensive reentry program that is more likely to show a positive program effect.

Exhibit 4
Total Net Fiscal Impact, Scenario One
Fiscal 2012-2016

Total Benefits	
Marginal Cost Avoidance (Exhibit 3)	$247,908
Variable Costs	
Direct Services at $2,500 Per Participant	-$3,125,000
Investor Return	
Return on Investment at 10%	-$312,500
Fixed Costs	
Program Evaluation	-$150,000
Contract Design	-300,000
Management Fee to Intermediary at $50,000 Per Year	-250,000
Net Fiscal Impact	**-$3,889,592**

Source: Department of Legislative Services

The remaining cost assumptions were also optimistic.

- The program evaluation costs were 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, and Maryland cannot simply replicate an existing contract model to avoid the costs of designing the contract with local and national partners. 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.

- The return to investors was budgeted at 10%, below the maximum 13% ROI amount used in Peterborough.

Using these figures, the fixed costs would equal $700,000, and total variable costs would equal $3,125,000. Combining these costs with the ROI and the fiscal benefits, the net cost of the program to the department would be approximately $3,889,592, as depicted in Exhibit 4.

This optimistic scenario reveals that a successful reentry program cannot self-finance using the cost savings to the government. The marginal cost avoidance represents less than 6% of the total costs of operating a SIB financed reentry program. If the program failed to demonstrate the targeted outcomes after a full five years of operations, the government would, at a minimum, incur $700,000 in costs as a result of the financing mechanism, due to the costs of the program evaluation, contract design, and management fee. The department's avoided cost of direct services, funded by the loss of investors' capital, would depend on the ability of the contract to effectively shift financial risk onto investors – an issue explored in greater depth in the limitation section of this analysis.

Scenario Two: 20% Recidivism Reduction and Lower Costs

Even if the assumptions in the first scenario are each modified to reflect a more optimistic set of assumptions, the net fiscal impact of a successful program would still remain negative.

Two primary adjustments were made to model a highly optimistic scenario:

- the program effect was revised upwards from 10 to 20%; and

- the management fee to the intermediary was revised downward from $250,000 to $150,000.

As **Exhibit 5** depicts, an increase in the expected program effect from 10 to 20% results in a 100% increase in the prison beds avoided and total cost savings from Scenario One. Before including the costs of operating the program using a SIB, the savings from a reduction in reimprisonment represent a maximum fiscal benefit per year of $179,141 and a total fiscal benefit of $495,817 over a five-year period. However, even under this highly optimistic set of assumptions, only a maximum of 39 prison beds are avoided in fiscal 2016. The department is only able to close a facility when the number of beds saved each year is consistently at least several hundred per year.

Exhibit 5
Schedule of Benefits, Scenario Two
Fiscal 2012-2016

Year	No. of Program Participants	Returning to Prison Before Program Effect (No. of Persons)	Program Effect (No. of Persons Not Going to Prison) Current Year	Prison Beds Saved	Cost Savings
2012	250	27.5	-5.5	3	$12,713
2013	250	50.0	-10.0	11	48,542
2014	250	67.5	-13.5	22	102,862
2015	250	67.5	-13.5	33	152,559
2016	250	67.5	-13.5	39	179,141
Total	**1,250**	**280.0**	**-56.0**	**107**	**$495,817**

Source: Department of Legislative Services

Exhibit 6 provides a comparison of the cost savings with the variable and fixed costs. Using these benefits to inform an assumption about the cost of direct services, it is apparent that a program that approaches fiscal balance would have very little funding available for direct services. Even after doubling the assumed efficacy of the program, the fixed costs of a SIB program alone would exceed the fiscal benefits. This means that any money spent on direct services increases the net negative fiscal impact of the program to the government.

Exhibit 6
Total Net Fiscal Impact, Scenario Two
Fiscal 2012-2016

Total Benefits	
Marginal Cost Avoidance (Exhibit 5)	$495,817
Variable Costs	
Direct Services at $250 Per Participant	-$312,500
Investor Return	
Return on Investment at 10%	-$31,250
Fixed Costs	
Program Evaluation	-$150,000
Contract Design	-300,000
Management Fee to Intermediary at $30,000 Per Year	-150,000
Net Fiscal Impact	**-$447,933**

Source: Department of Legislative Services

Using $250 per participant to illustrate the fiscal dynamics at the lowest conceivable cost still results in a net fiscal impact of -$447,933 over the life of the program. A program with only $250 to spend on direct services per participant would provide very limited services. Low intensity interventions are not likely to produce a reduction in recidivism close to 20%. Exhibit 6 depicts the total net fiscal impact of the program across all five years of program operations using this second order, final modification of the assumptions from the first scenario.

Doubling the size of the program does not alleviate the negative fiscal impact. Even under highly optimistic assumptions, a program that had 500 participants complete the program each year would only reduce the demand for prison beds by a maximum of 78 beds in year five of the program, a reduction in demand well below the number needed for even a partial facility closure. For a pilot program then, the fiscal impact is determined by the benefits associated with the avoided marginal costs per inmate and the costs of offering the reentry programming. Given these dynamics, even under optimistic assumptions, it is apparent that a highly effective program cannot self-finance.

Accuracy of Fiscal Estimates

These projections are not intended to reflect actual DPSCS experiences with reentry programming. The actual relationship between reentry programs and the demand for prison beds is unknown. Because the department has discretion over facility use and prison bed demand is driven by complex interactions between crime, detection, the judiciary system, sentencing, and DPSCS discretion, a one-to-one relationship between recidivism and State prison bed demand is unlikely. The relationship between reentry programs and prison bed demand was assumed to be direct in the scenarios above, yet the cost dynamics were not positive. The true interactions are likely to be less favorable to strategies attempting to finance pilot reentry programming through cost savings experienced during the life of the program.

Both scenarios described earlier neglect the fiscal impact outside of the cost of reimprisonment for expenditures related to parole and broader social services funded by the State. In the case of avoided parole, there may be some additional savings, but the cost of parole is generally much smaller than the marginal cost of imprisonment. For other cost dynamics, reentry programming may increase direct costs to the State, at least in the short term, by increasing the percentage of released former inmates who enroll in State-funded social service programs.

A more accurate forecast would require significant investments in data collection and analysis. Beyond developing a working model of the relationship between sentencing and prison demand, modeling cost dynamics prospectively would also require forecasting crime levels, prison populations, policy changes, and funding streams from non-State sources. Even retrospectively, it can be very expensive due to the difficulty of collecting and harmonizing data collected in separate systems. At the current time, Maryland does not even have the capacity to estimate general population reimprisonment rates (though DPSCS is implementing a new data system that should improve data collection and analysis abilities within the department).

Though it may be difficult to model the cost dynamics with greater accuracy, the general dynamics will not change. Prior experiences with programs for reentry, including the Peterborough SIB program, have demonstrated that effective pilot programs cannot finance themselves with cost savings. An independent evaluation, commissioned by the U.K. Ministry of Justice and conducted by RAND Europe found that the reentry pilot program in Peterborough is "too small to deliver substantial 'cashable' savings (monetized benefits)."[4] Additionally, a study entitled *Impact and Cost-benefit Analysis of the Maryland Reentry Partnership Initiative*, conducted by the Urban Institute Justice Policy Center, found that a pilot reentry program offered in Baltimore did not produce savings for the government. The report noted that "when community-justice partnerships work – whether they are reentry programs, drug courts, or some other intervention – the benefits tend to disproportionately accrue to private citizens, rather than public agencies. That is, public agencies looking to programs…as a means of creating revenue streams that more than offset the cost of the program are likely to be disappointed." The

[4] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, RAND Europe, 2011, pg. iv.

Maryland Reentry Partnership Initiative cost $3,476,240 to administer for a cost of $6,213 per participant. It saved public agencies $2,961,650, though the estimate for correctional spending was made using average costs instead of the more accurate marginal cost methodology. Even with this generous inflation of avoided correctional costs, the program still had a net cost. These examples suggest that direct cost savings are insufficient to finance pilot reentry programs.

Nonfiscal Value of Programming

It is important to note that this case study centers on the efficiency and cost effectiveness of a SIB for financing and operating reentry programming, relative to direct government operations. Reentry programming should be as cost effective as possible and operated in the most efficient and equitable ways available. But the decision to engage in reentry programming hinges on much broader, nonfiscal considerations than whether or not a SIB is an efficient way to finance reentry programs.

Reentry programs are intended to help prisoners who are leaving incarceration successfully return and adjust to their local communities. Incarcerated individuals undergo a very difficult adjustment process upon entering incarceration that "can create habits of thinking and acting that are extremely dysfunctional outside the prison walls."[5] The longer individuals are incarcerated, the more they adapt to a prison environment that encourages heavy dependence on institutional structures, hypervigiliance and interpersonal distrust, and social withdrawal, among many psychologically painful effects. Simultaneously, prisoners experience diminished ties to their family and social networks.

At the time of the release, individuals return to the community with norms and attitudes that are maladaptive to society outside of the prison walls. Compounding the problem, many, if not most, have weak labor market attachments and social supports. Reentry programming can thus provide a highly socially valuable set of services, independent of the fiscal impact, that contribute toward stronger and safer communities when former inmates are able to begin rebuilding healthy and productive lives.

Limitations of the SIB Model

Substantial Risk Shifting Unlikely to Occur

Even if a SIB reentry program cannot self-finance through cost savings, the potential to shift outcome risk to the private sector could in theory provide benefits to the government that justify the added costs incurred in this financing mechanism. Unfortunately, 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

[5] *Prisoners Once Removed*, The Urban Institute, pg 39.

contract design must provide an enforcement mechanism to prevent investors and providers from terminating the contract early.

Unlike municipal bond markets, a market for high-risk instruments to finance government social programs does not currently exist. The department would have to incur substantial costs in selecting partners and designing the contract in order to discover whether or not there was indeed an appetite for a reentry program in the State.

Furthermore, eligible partners must tolerate long-term financial risk that is enforced by a mechanism that prevents early termination. Without such a mechanism, the ultimate financial and operational risk would be with the government. The only risk shifting that would occur without an enforcement mechanism would be for the initial operations that are necessary for the third parties to evaluate cost and the likelihood of achieving the specified outcomes.

Peterborough provides insufficient guidance on how to design such a contract. An independent evaluation found that the risk "transfer, and the contracts themselves, are untested in many respects: issues that challenge the contractual arrangements and/or require clarification through the contracts could still arise in the course of implementation."[6] A large amount of this uncertainty is driven by the complexity of the contract: "Complexity in some instances meant that the actual transfer of risk is not clear."[7]

Even if a contract could be designed to effectively limit investor termination, there would still be the possibility that the funds would not cover the cost of program operations. Under more standard forms of performance-based contracting, providers and the government can renegotiate the contract when the cost drivers differ from initial estimates. The inclusion of external investors and a rigorous independent evaluation in a SIB, however, significantly limits the flexibility to renegotiate contracts – a flexibility that has been critical for many jurisdictions engaged in more standard forms of contracting for human services.

To remedy the cost reimbursement problem, some hybrid models of social impact bonds have been proposed where the government assumes from the start a majority of risk. Under these proposals, the government pays for a substantial portion of the program operation costs. In some proposals, the government would guarantee 70% of program costs. However, in a SIB model where the government guarantees 70% of the program costs, the costs of designing the contract and compensating a third-party intermediary are close to the dollar value of the risk shifting for the government.

In short, even if a market for investments in Maryland based SIBs were to exist, it is unlikely that the government will be able to shift the financial outcome risk for the program substantially onto the private sector given the difficulty of preventing service providers and investors from leaving a potentially underfunded and/or unsuccessful enterprise. If risk cannot

[6] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*, RAND Europe, 2011, pg. 54.

[7] *Ibid.*

be in practice shifted to the private parties through an effective enforcement mechanism to prevent early termination, Maryland would in fact be increasing its operational and financial risks with the decision to engage in the project. In the event that the private parties cancelled the contract, there may be strong political, ethical, and administrative reasons for continuing a program through direct government funding.

Added Expenses in SIB Model Create Additional Budgetary Pressure

Implicit in discussions of SIBs is the notion that they can alleviate underfunding of specific social services by leveraging private capital. The ability of SIBs to alleviate funding challenges is based partly on the idea that capital projects are typically better financed, due to recognition that the benefits of capital projects accrue over a long time period. In order to spread the cost of capital projects across the useful life of a project, governments typically borrow money through bonds and repay them over time, breaking the limiting link between upfront costs and total benefits. Social programs, in contrast, are constrained by annual appropriations in the operating budget – even though the benefits also accrue over a long time period. Preventing a future violent crime may cost more in the short term but will save a large sum of money over time through avoided incarceration, for example.

Even if a specific social program could reap fiscal savings with increased upfront funding, SIBs would not solve this problem. Because of the uncertainty of the payments made by the government, both Massachusetts and the U.K. government have planned in their budgets to make the full payment necessary to fund the program and pay investors their ROI.

Budgeting for contingent liabilities is good fiscal policy. It would be risky and imprudent long term to incur contingent liabilities without providing funding. But in practice, this means that operating expenditures for a SIB program will be allocated either in advance or annually for the full cost of the program, in the event that the program works and the government must make the outcome-based payments. The government, therefore, realizes no upfront savings to finance the program and is still limited by current operating budget constraints.

High-stakes Payments May Distort Evidence

Common conceptions of SIBs assume that unproven programs are the types that investors, providers, and the government will prefer for high-risk outcome payments. However, given the financial and reputational stakes attached to SIBs, governments and parties to the SIB are more likely to select programs and partners with well-established records of performance. Selecting providers based on their likelihood to succeed, in the case of a SIB pilot, can create the false impression that the specific intervention could be scaled to a larger operation.

In Peterborough, for example, the program location and partners were not chosen randomly from a pool of qualified providers and relevant locations. Instead, the providers were selected based on their existing partnerships, proximity to the prison, and established track record for high performance. Even if the Peterborough SIB achieves positive outcomes, it will

still be unclear if this type of program can be replicated in other locations without the advantages produced from location and partner creaming.

Additionally, even if new programs are piloted, if private parties cannot in practice be prevented from leaving contracts early, this may distort the nature of the evidence base. In the event that private actors decide not to wait for medium- to long-term positive outcome indicators and cancel the program when the short-term outcomes appear unfavorable, this would distort the production of new evidence for any programs that may require longer periods of time to demonstrate efficacy.

The Evaluation May Be Inconclusive

SIBs are designed with the intention of offering governments the ability to increase the portion of payment based on performance. This is one of the primary innovations of the SIB concept. In order for this to function, there must be an increased confidence in the assessment of the outcome and its causal drivers.

It is not sufficient to say that a treatment group exceeded the average outcome. Instead, evaluators must build a group to control for effects of causal factors that are independent of the specific intervention. In the most rigorous evaluations, research protocols are designed around random assignment to minimize the effect of unmeasured differences between the control group and the treatment group in the program. Random assignment can be both operationally and cost prohibitive, however. In the Peterborough pilot, for example, there were concerns about denying treatment randomly within a single prison. Many evaluations and research studies construct simulated control groups instead (usually by using propensity score matching). This is considered the next most rigorous form of evaluation.

However, the simulated control groups are not capable of controlling for unmeasured variables, as the control groups are not random but rather assembled based only on observed characteristics. This means that there is an unknown risk that the observed outcome was caused by an unmeasured variable. This problem was noted in a government commissioned evaluation of the Peterborough program.[8] The report indicated that the methodology used in Peterborough did control for basic demographic data and was the most rigorous methodology available apart from random control assignment. But it "cannot take account unmeasured differences…aside from treatment received."[9]

However, regardless of the technique, in small studies it is harder to tell whether or not the intervention was the result of random variation. In other words, even if there is conclusive evidence that the treatment group differed in important ways from the control group in terms of outcomes, this difference may be random. The risks of this occurring are higher in smaller samples.

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[8] *Peterborough Social Impact Bond: an independent assessment*, May 2012, Ministry of Justice Research Series, pg 8.

[9] *Ibid.*

In practice, expert researchers rarely use a single study as proof that a type of intervention works. The value of research and program evaluation is in the cumulative evidence. A problem with SIBs is that they depend on a high degree of confidence in a single evaluation for the entire payment.

SIBs and Narrow Policy Change

Program models for a SIB financed reentry program start services with individuals at the time of release and provide social services, such as housing, job counseling, and therapy. From a broader policy perspective, this type of reentry program represents a very narrow policy change relative to the total number of practices and policies that impact rehabilitation, community reentry, and recidivism. Other jurisdictions, including jurisdictions in Maryland, address reentry programming as a comprehensive process that begins at admission to the prison. As such, if the goals surrounding reentry programming are to reduce expenditures on imprisonment while increasing public safety and social welfare, a host of broader policy changes can be enacted in complement to programs that provide services directly at the time of release. Many of these, in fact, have already been identified by the Maryland Task Force on Prisoner Reentry.

Post-release employment, for example, is a key causal determinant of both successful community reintegration and reduced recidivism. While reentry programs can help facilitate prisoners' adjustment to reentry and, therefore, potentially increase their employability, the difficult barrier of employment discrimination for those with criminal histories remains. To combat this problem, in a report issued last year, the task force recommended a law to shield criminal records for nonviolent convictions from public view after an appropriate waiting/proving period. This is an example of the types of synergistic policy change that can complement reentry programs to save the State money while increasing social welfare.

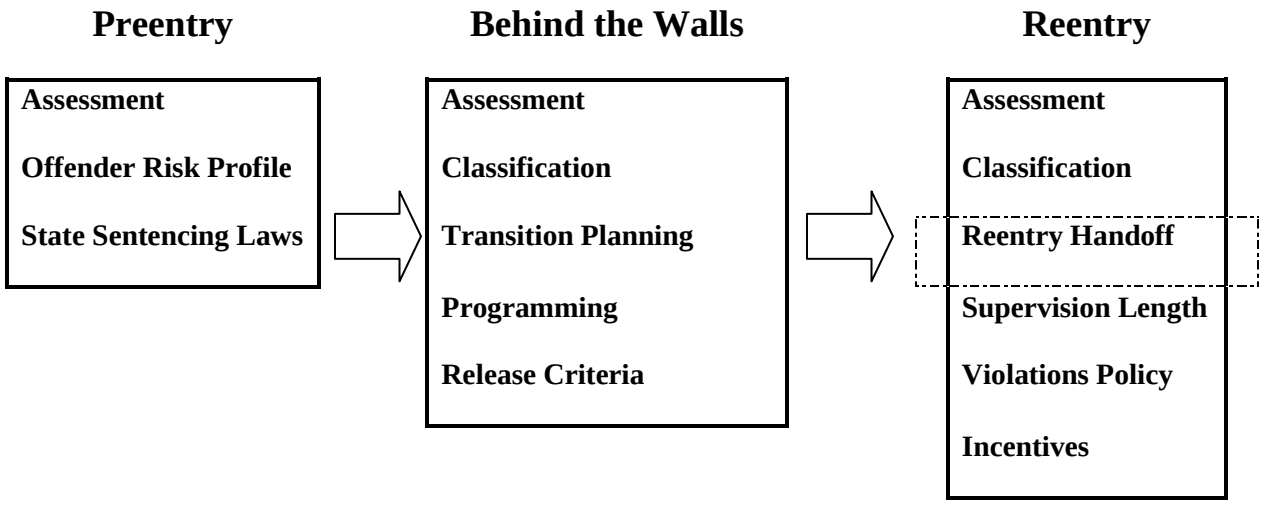
The policy mechanisms with the greatest leverage available to reduce prison expenditures while enhancing public safety exist in sentencing and release criteria reforms. Whereas reentry programs work to reduce the number of prisoners indirectly, sentencing and release criteria reforms can directly decrease the number of low-risk offenders who are sent to and/or retained in prison. As one example, in the 2012 *Joint Chairmen's Report* response on the Plan for Reducing the State Inmate Population, the department estimated that increasing the number of good conduct credits that nonviolent prisoners are eligible to earn could save the department up to $29 million annually. The department found that this was a sustainable option that provides extra incentives for good behavior to inmates coming into the system and would increase safety in prison facilities.

This type of policy would complement reentry programs, as prisoners who spend longer time periods incarcerated generally have a harder time re-integrating into their local communities. Longer separation periods, for example, decrease the likelihood of mothers retaining custody of their children. Reducing the time served in prison for offenders who would be more effectively and safely rehabilitated in the community, while maintaining supervision by

the department, would help reduce the heightened psychological difficulty of reentry associated with longer prison terms.

A reentry program financed by a SIB, in contrast, represents a very narrow policy change, as depicted in **Exhibit 7**. A privately operated reentry program would start services at or near the point of release for prisoners, labeled as the "reentry handoff" in Exhibit 7. This is just one of a larger number of institutional policies and practices that impact the community reintegration and/or recidivism of those committed to the department's supervision.

Exhibit 7
Policies and Practices That Effect Recidivism



Source: Adapted from the Pew Center on the States

The narrow focus of a SIB reentry program poses three problems to a state engaged in or considering broader policy change:

- Because SIBs require high degrees of statistical control in order to determine causality, the confidence in the justification for the high-stakes outcome payments may be placed in jeopardy when a large number of important environmental and demographic factors are modified during the pilot program. If it were possible to control for these changes, the baseline outcome goals may still require modification to account for demographic and environmental changes. Making these modifications to a contract would be time consuming and expensive.

- A SIB financed program would create a new system of private service delivery external to the department. In some cases, this may be counterproductive where integration between current DPSCS programs would increase efficiency and efficacy. Reentry programming often starts in many jurisdictions at the point of entry into the prison system. Creating a parallel system separately administered by the private sector may impede operational integration, a problem that may be especially difficult if the department were to engage in large scale re-organization and/or policy change.

- Building a highly sophisticated contracting mechanism to focus on one narrow aspect may impede the capacity of agencies and the State to engage in broader policy evaluation and change. Developing a SIB for a reentry program would require significant investments of staff time to design and manage the contracting process. This may impede the department's ability to simultaneously enact other large complementary changes that require budget, contracting, and senior staff time.

Conclusion

A reentry program financed using a SIB would not produce sufficient benefits to justify the operational costs or risks of engaging in this form of high-stakes contracting.

A social impact bond financed program would:

- increase budgetary pressure compared to direct financing, due to the necessity of funding contingent liabilities and the added expenses of features unique to SIBs;

- not produce cost savings when outcomes are achieved, even under highly optimistic assumptions;

- be unlikely to shift outcome risk;

- possibly exclude new providers and program types that do not have a well-established record of success through investors seeking to minimize risk; and

- potentially distort evidence used in policy decisions.

The primary weakness of a SIB is in the complexity of its moving parts and the high-stakes nature of the financing mechanism. A SIB contract would only be advantageous to Maryland, if, at minimum, all of the following conditions were met:

- Maryland could create a contract that guarantees investors and providers will continue program operations for the entire life of the contract, even when it is apparent after the program starts that the outcomes are unlikely to be achieved.

- Nonprofits would continue service delivery when reimbursements are below costs **or** all parties could effectively and efficiently renegotiate the contract without jeopardizing the evaluation and value of the risk shifting to the government.

- An independent program evaluation could definitively show that the program either did or did not cause the target outcomes to be achieved.

- The additional costs inherent to the SIB financing mechanism would be sufficiently lower than the cost of providing the service, so as to justify the value of these services to shift the outcome risk.

- A private market can be created for investing in unproven forms of reentry programs.

- The department has the operational capacity to engage in a SIB pilot program while undertaking other organizational and policy changes.

- There is sufficient State funding in the operating budget available to fund the contingent liabilities of a SIB program.

- The value of shifting the risk for a negative outcome is monetarily large enough to the government to risk the added costs of the SIB and the potential for an investor ROI given a positive outcome.

If any one of these conditions cannot be met, then a SIB model is not an ideal financing or contracting mechanism for reentry programs in Maryland. Given the difficulty of shifting the outcome risk and the countervailing incentives for many of these conditions, it is unlikely that these conditions will be met.

Reentry programs can have social value well beyond the direct fiscal costs to the government. They are especially valuable and fiscally beneficial when developed in tandem with complementary policies that have an even greater impact on recidivism. However, SIB financing mechanisms create a host of problems that collectively limit the purported benefits of the financing mechanism and the ability of governments to engage in broader policy changes.

Recommendation

DPSCS should continue to directly finance and operate reentry programs while pursuing other organizational and policy changes likely to have greater impact while posing less risk than a SIB financed program.