

The Bond Market and Public Safety

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Abstract

At least 40 states face swelling budget deficits. Likely targets for reductions include the discretionary social programs that protect public safety. Rather than jeopardize the public's safety and well-being with imprudent cuts, a different and better way out of the financing crunch is explained by two criminologists: the social impact bond.

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State and local governments are in trouble. At least 40 states face swelling budget deficits. While few details of next year's budgets are available, likely targets include the discretionary social programs that protect public safety.

Often, programs that serve criminal offenders, at-risk youth, people with mental illness and drug addictions, and prisoners returning home are the first to get hacked when budgets are cut. In a preview of what is likely to come, governors in Virginia, Texas, and New York have proposed cutting funding for at-risk youths, increasing the chances of future crime increases.

Rather than jeopardize public safety and well-being with imprudent cuts, here's a different and better way out of the financing crunch: the social impact bond (or SIB).

This new financing tool helps improve communities and stimulate investment in effective social programs by harnessing the private sector's power. SIBs invite investors to earn a profit by supporting public programs that reduce social problems, thereby obviating government expenditures and channeling the savings to investors.

Here is how SIBs work. First, researchers pinpoint a program that has made proven headway against a costly social problem—that is, a program that generates benefits in excess of its costs. The government, or a private institution, then issues a bond to finance the program. The bond offering specifies ways to carry out the program, the target population, the size of the investment, and the expected yield. Private investors subscribe to the bond and—once it has run its course—-independent evaluators assess the program's performance to confirm that pay-off targets were met. If they are, government then returns the initial investment to bond holders along with a profit.

Britain launched the first social impact fund last year. A social investment bank called Social Finance issued a 5-million pound bond to finance services for 3,000 recently released prisoners. Private investors, including community foundations and other charitable organizations, purchased the bond with the promise that if recidivism among the returning prisoners was reduced by 7.5 percent, they would receive a 7.5 percent return on their investment after six years, paid by the government. Even larger reductions in recidivism would result in greater returns.

Why would investors buy such bonds? Private donors, charities, and charitable foundations whose mission is to do good work and improve communities are betting that the profits they earn will allow them to do even more good work and more community development than they otherwise could. If the program flops, they are no worse off than if they had invested directly through grants.

For government, the bonds are nearly risk-free. If the program fails, no public funds are lost. If it succeeds, the government pays out only a fraction of the savings it receives from reducing the costs of arrest, prosecutions, and incarceration—in the British example, government expects to keep roughly two-thirds of the savings.

Premier Kristina Keneally of the New South Wales government in Australia recently lauded SIBs as a way of "unlocking funds to tackle social issues" through community, financial, and government sectors. And SIBs could spread outside charitable giving and entrepreneurial foundations. Last month, the *Financial Times* reported that JPMorgan Chase and Deutsche Bank, among others, are exploring the use of SIBs, believing that they could become a "tradeable asset class."

The best candidates for SIBs are programs most endangered in tough times because they are high-priced.

Therapeutic foster care—on Virginia’s chopping block—is a perfect example. The Centers for Disease Control and Prevention endorses the program—which teaches foster parents how to help youth with a history of antisocial behavior—as effective despite the high cost (several thousand dollars per youth), and the Washington State Institute of Public Policy (WSIPP) found that the program can yield tens of thousands of dollars in long-term benefits to the youth and their communities.

If Virginia doesn’t have the money right now, instead of cutting the program by \$7.5 million, it could solicit the same amount from private investors to fund a social investment bond. The SIB would incorporate a target goal for effectiveness, perhaps based on WSIPP estimates that therapeutic foster care reduces new offending by 37 percent. Once the goal is reached, the bond would pay back investors their original investment plus a healthy profit but also save government millions, according to WSIPP.

State and local governments across the United States are wrestling with the worst fiscal crisis in nearly a century. As revenues decline and obligations mount, city and state officials face a double whammy: just when social programs are needed most, operating funds are scarcest.

Safety (in this case) and the public good (more generally) dictate continued funding for effective programs with long-term benefits, but recession politics naturally breeds short-term thinking. Stimulating private investment in cost-effective social programs could make long-term thinking more profitable and make entire communities better off even in these tough economic times.

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