

The Archerfish Foundation

Submission to the Senate Economics References Committee:
Inquiry into Finance for Social Organisations

Social Impact Bonds: Key Design Ideas

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Contents:

	<i>Page:</i>
<i>Abbreviations</i>	3
<i>Glossary</i>	3
Executive Summary	4
1. Introduction	6
2. The Role and Purpose of Social Impact Bonds	7
2.1. Type A Social Impact Bonds	8
2.2. Type B Social Impact Bonds	10
3. Ensuring Efficient Outcomes	12
4. Funding Social Impact Bonds	12
5. Conclusion	13
6. Recommendations	14
<i>References</i>	15

Abbreviations:

ASIC	Australian Securities & Investments Commission
IP	Intellectual Property
NFP	Not for Profit
NGO	Non Government Organisations
PBAC	Pharmaceutical Benefits Advisory Committee
PBS	Pharmaceutical Benefits Scheme
RCT	Randomised Control Trial
ROI	Return on Investment
SIB	Social Impact Bond
SIBIO	Social Impact Bond Issuing Organisation

Glossary:

BOND	A financial instrument that allows an issuer to raise capital. The bond issuer is obliged to repay the initial amount borrowed (the principal) plus additional interest payments over the life of the bond.
EFFICIENCY	The use of resources in a manner that maximises the potential output from the given inputs.
KALDOR-HICKS EFFICIENCY	An outcome is judged to be more efficient if those that are made better off could (at least in theory) compensate those that have been made worse off in order to achieve a Pareto optimal outcome.
INCREMENTAL COST EFFECTIVENESS	The incremental benefit of an intervention relative to its alternatives.
MARGINAL COST	The change in cost when the quantity produced increases by one unit.
MONOPOLY	A market in which there is only one provider of goods and/or services.
MUNICIPAL BONDS (U.S.)	In the United States, a Municipal bond is a security that is issued for the purpose of financing the infrastructure needs of the issuing municipality e.g. schools, roads, public housing etc. Depending on the State in which it was issued, revenues generated from them are except from most Federal and State taxes.
SOCIAL PROVISION	Public goods such as health, juvenile justice, child protection, disability services, public housing etc. usually provided by public agencies.

Executive Summary

Social Impact Bonds have morphed into a variety of different forms since first discussed in 2010^(1; 2). The model as initially proposed sought to promote the achievement of cost effective returns on small-scale social projects with measureable outcomes. We refer to this initial form as Type A bonds. We suggest that one variation, denoted Type B or “industrial strength” Bonds, could be used to transform areas of persistent social policy failure, by applying and rewarding a payment-by-results approach to service delivery. Type B bonds resemble the modus operandi of private equity in which investors subscribe capital to a fund manager that manages a portfolio of projects. The fund manager negotiates a contract (bond) with government that commits government to repay agreed capital investments and to make incentive payments contingent upon the fund manager achieving agreed outcomes. The fund manager makes no commitment to using existing non-government-organisations as their service delivery organisation. Indeed, the fund manager may choose to create a new delivery organisation to fulfil the requirements of the contract. Potentially, the successful fulfilment of a contract addressing areas of persistent social policy delivery could earn investors large returns.

We recommend that actions taken to ensure the efficiency of Type B bonds might include:

1. A requirement that all Intellectual Property created in the course of a successful contract transfers from the delivery organisation to the public agency responsible for service delivery in the contract domain;
2. At contract termination, the delivery organisation takes steps to transfer knowledge and skills acquired in acquitting the contract to the public agency;
3. Assuming that the fund manager receives 50% of the value of performance improvements or “cashed-out” inefficiencies, the remainder of the value of the performance gains is credited to the public agency.

Finally, we propose that the value of the performance payments made to the fund manager should be subject to advantaged tax treatment, such that the fund manager should receive tax credits for supporting financially and with management expertise, the bond raising efforts of small community-based not-for-profits that meet two conditions:

- a) Marketing and advocacy activities are capped at an appropriate percentage of their operational expenses and;
- b) The not-for-profit has a value proposition that has been audited and shown to be cost effective.

The biggest challenge facing the Not for profit sector is not a shortage of funding but a demand for relevance. It is impossible to see how not for profit organisations can flourish without its members having charitable intent and goodwill. But not all charitable intentions have to be funded with public money. It is indisputable that resources are limited and to make best use of the resources available these should be directed to recipients who can apply funds in the most cost-effective manner possible. Funding should be exclusively directed to not-for-profit entities that can show they have a value proposition based on the creation of cost-effective outcomes,

not the most persuasive marketing campaign, energetic street hustlers or the call-centre most capable of carpet-bombing donors with appeals for funds.

Social impact bonds are not a magical source of funding but they could be a useful way of focusing small NGOs on producing cost-effective outcomes that government is more likely to purchase. The primary purpose of Type B, or “industrial strength” bonds is to transform service provision in areas of persistent social policy failure by (temporarily) transferring accountability for service delivery to “fit for purpose” organisations. In our formulation of Type B Bonds, the benefits to society are that SIBIOs that successfully produce better outcomes through innovative practices will transfer the Intellectual Property developed to public sector agencies during and at the end of their contracts and if SIBIOs can attract tax advantaged treatment of returns from their better performing interventions, we could have an almost magical source of funds for Type A Bonds.

1. Introduction

Will Hutton captured something of the contest of economic principles and responsibilities underlying social provision in his manifesto for a fair society⁽³⁾.

“There is a co-dependency between the public and private spheres that creates innovation and business franchises. The public realm is the custodian of fairness, houses the checks and balances that keep capitalism honest and is the architect of the institutions that allow whole societies to take risks and drive forward their economies.”

Periodically our society examines the way social provision (health, juvenile justice, housing, disability services, child protection) services are delivered and finds significant fault with the quality, quantity, scope and adequacy of the State’s delivery of its responsibilities in these areas⁽⁴⁾. Occasionally, investigations find fault with the delivery organisation’s loss of focus on its mission and its implicit belief in its entitlement to set public expectations about service delivery standards.

Commissioners may recommend that the public interest would be best served by transferring accountability for service delivery elsewhere⁽⁵⁾. One of Wood’s core recommendations was that resources should be transferred from the Department of Community Services to other government departments and the non-government sector in expectation that the scope and timeliness of service delivery by the NGO sector would more adequately meet demand.

This is not solely an Australian problem. A UK Government report *Smarter Government* set the scene for the launch of Social Impact Bonds (SIBs) a part of a broader agenda aiming to strengthen the role of citizens and civic society⁽⁶⁾. The plan had three central actions: to drive up delivery standards by strengthening the role of citizens and civic society; to free up public services by recasting the relationship between the centre and the frontline; and to streamline the centre of government, saving money through sharper delivery. Informally, the intent of the report was to advocate the injection of market disciplines into the delivery of public services.

There are over 600,000 NFP organisations in Australia competing for public donations and government funding, little of which is disbursed efficiently throughout the sector. Some causes and issues accumulate a disproportionate share of the charity dollar at the expense of other – essentially unfashionable – causes. This has resulted in an NFP sector that is overrepresented by organisations for whom marketing and advocacy are a priority, channelling resources away from more socially beneficial uses.

Social Impact Bonds were hailed as a ground-breaking approach to funding social provision service delivery by moving access to funds into the hands of community-grounded social entrepreneurs who are rewarded on the basis of their results. The purpose of this paper is to point out some of the emerging gaps between the initial concepts and stated purposes of SIBs and how these are changing in the light of evolving thinking about how service delivery might be transformed. In our view, Social Impact Bonds have the potential to be transformative.

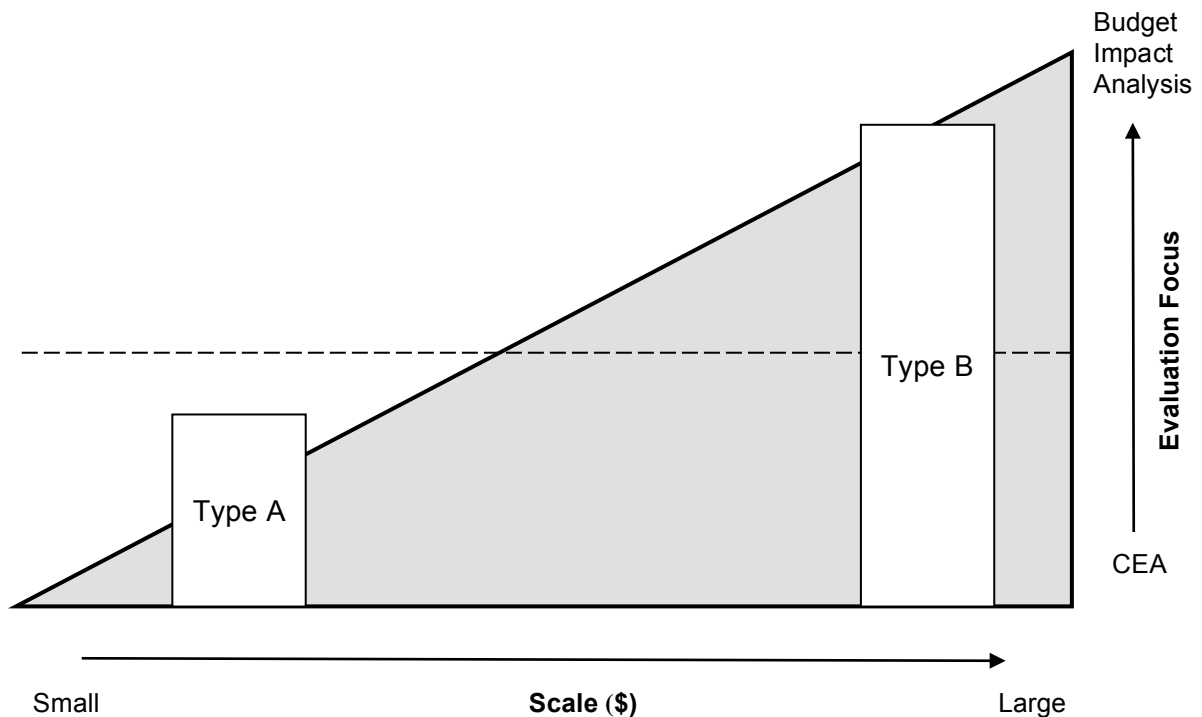
2. The Role & Purpose of Social Impact Bonds

A bond has the capacity to encourage business disciplines in the debt issuer more effectively than a loan does. Bonds are rated by independent ratings agencies and the better the rating, the cheaper the cost of debt. Bonds can be traded in a way that loans cannot. Generally, it should be noted that transaction costs to execute a bond can be punishingly expensive, especially for a new or one-time entrant into the bond market, even the philanthropic bond market.

Social Impact Bonds serve multiple purposes, two of which are innovation and social gain. Firstly, SIBs may serve to incent innovation in social provision delivery. Secondly, SIBs may fund incentives and investments designed to deliver large-scale social gain. The cost of these investments is recovered from avoided future cost of social provision. Tangentially, SIBs may serve to connect well-funded private investors, philanthropists etc. with service delivery agencies that may well benefit from the expertise and networks that investors bring.

Notwithstanding the potential benefits of SIBs, caution is required in their implementation lest one gets 'caught up in the hype'. SIBs are not a panacea and there are a myriad of interventions for which they are not appropriate. For example, interventions for which there is no measureable outcome like supportive telephone support services, or interventions where the cost of measuring effectiveness may outweigh their social benefit, like homeless patrols. Generally speaking it would be preferable to examine the effectiveness of innovative social funding with a small series of model experiments, and scaling up on the basis of proven experience. Two scenarios illustrate how two different types of SIB can improve innovation in service delivery and accelerate positive social outcomes.

Figure 1: Scale & Focus of Type A versus Type B Social Impact Bonds



2.1. Type A Social Impact Bonds

Scenario A: Community-based self-help organisations may develop communities of practice with new ideas for social gain and may need investment funds in order to develop and scale up their innovations. For example, a community of practice may evolve from a parents group established with the initial goal of supporting the parents of premature infants admitted to Neonatal Intensive Care units. With time, practice and insight, effective counselling, useable neonatal development strategies and parenting resources may emerge such that the parents group may evolve as a centre of expertise for parents, premature children and neonatal staff.

Organisations of this type and scale might be thought of as seedbeds for “diamonds in the dust”. SIBs would have the welcome effect of nurturing new practices which advantage society without necessarily being central to the government’s core social provision objectives of efficiency, effectiveness and equity. In this scenario, SIBs may have the appearance of an input-funding model. The model’s motivation rests on the assumption that NGOs lack investment capital for the establishment/refurbishment of their demonstrably effective clinical and service delivery models.

To some degree, the purposes to which Bonds may be put reflects the differences in intellectual heritage from which SIBs have arisen. The early proponents of SIBs, Mulgan and his colleagues at the Young Foundation, envisaged SIBs as a structured way of raising community funding to assist fledgling organisations with good ideas and agendas for building community capability and cohesion⁽¹⁾. Bonds, conceived in the formal sense of a promise to pay, were to be raised to fund start up and expansion costs. The bonds were to be redeemed both as a social dividend and

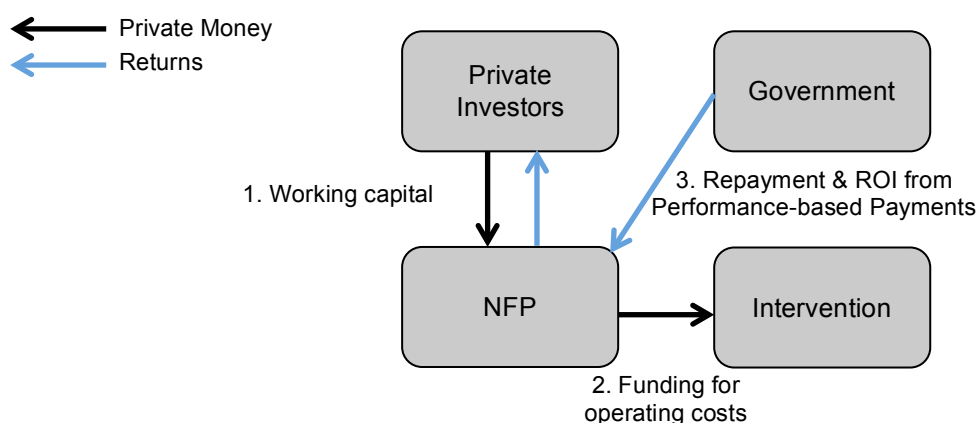
through payments from central and local government who would, in turn, benefit from avoided future costs of social provision. In this sense, bonds could be thought of as a form of long-term (<25 years) intra-generational cash transfer or demand avoidance. We shall refer to these as Type A bonds.

The Type A model is characterised by moderate outlays, say \$5-10 million and moderate delivery periods, say 2-5 years. Effectively it is a contracting model for purchasing specific social outcomes. It is ideally suited to a situation where the State wishes to investigate, catalogue and/or facilitate the development of a league table of effective interventions in various social provision domains. For example, the State might contract with an NGO to systematise their clinical/practical experience in providing parental training as part of a family preservation package. The contract might specify a checklist of deliverables such as:

- A systematic review of effect sizes achieved by parental training
- Itemisation of effective practice elements and guidelines.
- A clinical trial of best practices.

The key benefit to the State is that the NGO acquires capability and experience in effectiveness evaluation and an evidence base of comparatively effective interventions is assembled. In the longer term the State is empowered to purchase outputs from the NGO with confidence that a predictable level of results will be delivered. We surmise that the inhibitory effects of “overly prescriptive requirements, increased micro-management, requirements to return surplus funds and inappropriately short-term contracts” as the Productivity Commission characterised prevailing State purchasing practices, would become less prevalent if the State purchased outcomes that were auditably cost effective⁽⁷⁾. We also surmise that small to medium sized NGOs that refocused their attention to delivering cost effective services that worked would be well remunerated and would be less troubled by the need to raise funds to meet operating costs.

Figure 2: Capital & Repayment flows in a Type A Social Impact Bond



The funding of the Type A SIB model, as originally envisioned by Mulgan is predicated on the use of a debt instrument – a bond – defined in the formal sense of a promise to pay the debt in full at a specified time. The issuer of the bond also promises to pay a coupon (or interest payment) at agreed times. The Type A model was designed to operate under a set of principles, by which private investors (which

might include philanthropists or other charities), combine to purchase the issuer's debt. The money raised would be committed to the scaling up of the issuer's intervention model. If the intervention were successful, that is, if it achieved or exceeded measured outcomes contracted with the relevant public agency, the government would repay the investor's capital and pay an incentive coupon rate in excess of the bond's coupon rate. If, however, the NGO's intervention failed to meet or exceed the contracted outcomes, government would not be liable to return either capital or coupon. A bond shifts the risk of non-performance from State social provision agencies and State treasuries to the private sector. The key assumption is that the private sector will assume the risk either because the rewards are potentially financially attractive or the rewards might fulfil a philanthropic purpose.

Debt funding is not without difficulties and inefficiencies. There is a long history of the use of corporate bonds and a well-defined legal structure relating to rating, issuance, sale, default and/or redemption of bonds. In Australia, a corporate regulator, the Australian Securities and Investment Commission (ASIC) oversees the regulatory environment in which bonds are issued and traded. In all likelihood, Type A SIBs fall within the scope of ASIC's oversight. Bonds are rated by independent agencies and unrated bonds, normally classified as "junk", attract high coupon rates. Bonds are typically issued subject to complex legal contracts relating to the rights and responsibilities of the various parties to the bond. Much of the complexity follows from the fact that the State is not a party to the bond but shall be responsible for executing or contracting the verification or measurement of the outcomes claimed by the debt issuer. Finally, the tax status of coupon returns in the hands of investors requires clarification. The precedent of Municipal bonds in the U.S. indicates that an important factor determining the success of SIBs will depend upon some degree of privileged tax treatment of bond returns.

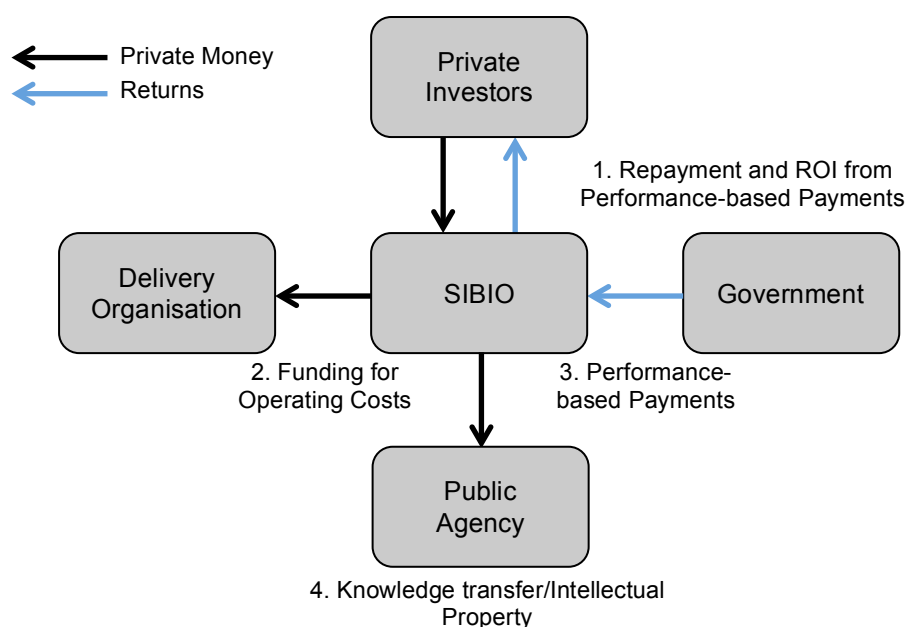
2.2. Type B Social Impact Bonds

Scenario B: The need to foster innovative and alternative ideas about social provision is greatest in areas of recognised social policy failure, where, most often, the service delivery agency of record is a public agency. It is no accident that the first pilot project involving SIBs, has trialled a program to reduce recidivism amongst young adult offenders leaving prison⁽⁸⁾. Other perennial failures include interventions with juvenile offenders, abating indigenous disadvantage, programs for mainstreaming services for the disabled and youth mental health strategies. The cost of failure and the value of entrenched inefficiencies in (often Federally funded) social provision initiatives probably totals hundreds of millions, if not billions of dollars in any 2-5 year period. The scale of capital investment and the timescale to deliver results is significantly greater than was envisioned for a Type A bond.

We shall refer to large scale SIBs as Type B. SIBs were first operationalised by *Social Finance Ltd.*⁽⁹⁾. Their model for SIBs has at its core a private equity-like organisation known as a Social Impact Bond Issuing Organisation (SIBIO) to which investors subscribe capital⁽¹⁰⁾. The SIBIO business model may involve establishing a new delivery organisation or refurbishing an existing organisation with a muscular, activist management approach that is not inconsistent with leveraged buyout

financing models (or private equity). It should be emphasised that SIBIOs may select any organisation suitable to their purpose to deliver their contract; they may choose not to use NGOs in any form. Type B SIBs may sidestep existing NGOs and directly confront the failure of public agencies to purchase or manage the delivery of effective social provision outcomes. The incentive remuneration provisions of a Type B SIB allow for the SIBIO or its delivery organisation to make investments and conduct its operations with the goal of delivering agreed outcomes at reduced cost. We expect that the incentive funding to the SIBIO derives from cashing out the entrenched inefficiencies arising from purchasing and delivery practices of the public agency and/or the NGOs previously responsible for service delivery.

Figure 3: Capital & Repayment flows in a Type B Social Impact Bond



Social Finance discarded the use of bonds, as conventionally defined, as a funding mechanism. They have retained the term bond partly for marketing purposes and partly to denote a contract with a public sector entity for the delivery of specified outcomes. The contract (or mandate) is the basis for raising investment funds from the private sector or, indeed any sophisticated investor. Social Finance acts as a venture capitalist might, sourcing capital and managing a portfolio of investments in delivery organisations. The business model relies upon targeting areas of recurrent social provision failure where the application of management skills may yield substantial productivity improvements (including from recruiting, retaining and incenting staff) and negotiating incentives from government for service delivery performance that exceeds the prevailing rate. By design, SIBIOs are remunerated contingent upon performance by having their agreed capital investments reimbursed, and incentive fees paid according to prior agreements for outcomes delivered.

The approach outlined by Liebman, generally follows the Social Finance model and is the basis for Pay for Success Bonds for which President Obama has provisioned \$100m in the US 2012 budget plan^(10; 11). The Liebman plan depends not on an assumption that the private sector is able to muster and mobilise more cost effective

interventions than those available to the public sector but that its modus operandi (that is, improved management and investment techniques, compared with public sector management) have a direct budget impact effect⁽¹²⁾.

3. Ensuring Efficient Outcomes

The cashing out of entrenched service delivery inefficiencies and the transfer of these rents to private investors might be viewed as politically unpalatable and Pareto inefficient. Under Pareto efficiency, a transaction outcome is more efficient if at least one person is made better off and nobody is made worse off. In Social Welfare theory this has been judged excessively restrictive, such that even voluntary exchanges may not be Pareto improving, making it almost impossible for any form of social change to occur⁽¹³⁾. Under Kaldor-Hicks efficiency, reform should be counted an improvement if the gainers could afford to compensate the losers and still be better off. In Table 1 below we show that not only how compensatory offsets could be paid by the SIBIO but in practice, we assert, should be. The key balancing item in the exchange is the value of intellectual property arising from the private sector’s innovation in service delivery strategies and transferring the gathered insights to the public sector.

Table 1: Compensatory Trade-offs between Private & Public Benefits	
Private Benefits (contractual rewards)	Public Benefits (compensatory offsets)
1. Agreed capital investment reimbursed	1. No investment required
2. Incentive payments valued at 50% of the addressable value gained (achieved savings).	2. No risk undertaken
	3. Draws 50% of the value of SIBIO’s achieved savings. Transfer to agency budget.
	4. Exclusive Intellectual Property (IP) rights for all programs and techniques
	5. Potential returns to IP licensing
	6. Knowledge and skills transfer to public agency personnel, during and after contract termination.

4. Funding Social Impact Bonds

Funding Type B Social Impact Bonds presents no particular difficulty since the capital and operating funds are provided by private investors in proportion to expected returns. The continuity of funding will depend mainly on the perceived success of early Type B bond issues and the evolution of a robust market for alternate service provision. Type A bonds are a more difficult proposition since the scale of Type A bond impacts is expected to be significantly less. In the UK, Mulgan noted that seed funding for SIBs might come from surplus funds (i.e. unclaimed prizes) held by the Lotteries Commission or by liquidating long dormant accounts in the banking system⁽¹⁾.

In NSW there is potentially a degree of overlap between the recipients of *Community Builders’ Grants* and community organisations described earlier as “diamonds in the

dust” or seedbeds of genuine innovation that would benefit from a more sustainable funding base than that provided by Community Builders⁽¹⁴⁾. Community Builders provides funding in the order of \$50m per year and in the absence of publically available evidence of impact or cost effectiveness, it might be safely assumed that the diversion of this amount into a SIB seed fund would provide a sustainable base from which to launch Type A SIBs.

In our view, establishing SIBs on a national basis will require some degree of taxation relief in the same sense that the US Municipal Bond market depends upon advantaged treatment of returns in the hands of bondholders. Our proposal is that returns to Type B bonds should be conditionally tax advantaged in the hands of the SIBIO, not the hands of the individual investors. We have in mind that tax relief to the SIBIO might resemble the form of tax relief on research and development (R&D) expenditure where it can be shown that the R&D expenditure has benefitted a Type A bond recipient. We propose that access to tax relief will be contingent upon evidence that the SIBIO has supported merit-based applications from Type A SIB debt issuers for funding and operational support. In other words, a portion of the SIBIO’s profit pool (prior to distribution) will be earmarked for Type A SIB support. In our view, this incentive will ensure that credentialed community organisations (that is organisations with an audited, cost effective value proposition and capped expenditures on marketing and advocacy) will be able to access both funds and guidance from mentors with practical business experience.

5. Conclusion

Whereas the SIBIO/Social Finance model is a payment by results contracting model where each intervention is likely to be a separate purchasing instance, the Type A model leads to an assessment of cost effectiveness and repeatable purchasing. In the manner of the pharmaceutical benefits advisory committee (PBAC), agencies, as purchasers of services from NGOs, will be able to estimate the return (expressed in outcomes) on their purchases of services. Eventually, agencies will face a supplier market fully informed of the cost effectiveness of their purchases.

The uptake of SIBs would likely lead to two major changes in characteristics of the NFP market. Firstly the market would likely consolidate as NFPs either pool resources to facilitate a Type B SIB or as non-innovating NFPs struggle to adapt to the new market characteristics. Secondly, SIBs would lower the barriers to entry for smaller NFPs wishing to operate a SIB yet who don’t possess the marketing/fundraising budgets of the industry’s juggernauts. Thus, those NFPs that are delivering cost-effective services will find it easier to access capital to scale up their services.

6. Recommendations

1. We recommend that the Senate Economic References Committee supports a proposal to tax credit returns to Type B SIBs in the hands of the SIBIO, i.e. before distribution to the capital subscribers. Approximately, 90% of the tax saving is to be distributed to Type A SIB applicants on a prioritisation basis which favours:
 - a. SIBs seeking funding to implement an impact evaluation or a cost effectiveness evaluation of their service(s).
 - b. Excludes organisations spending more than 20% of their combined operating budgets on marketing and advocacy activities in the absence of an audited evaluation of the cost-effectiveness of their services.
2. Federal (and, if possible) State government purchasing practices for social provision services should be reengineered to focus on the purchase of outcomes and where feasible using payment by results contracts.
3. Recognising the sovereignty of State budgeting processes, it should be encouraged that the various unevaluated *ad hoc* State based funding pools e.g. Community Builders (NSW) should be consolidated and repurposed as seed funding for Type A SIBs.

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