Use of Social Impact Bonds to Assist Financially Distressed Municipalities

Karen S.D. Grande
Locke Lord
2800 Financial Plaza
Providence, RI 02903
401.274.9200
www.lockelord.com

Claudia J. Matzko
Locke Lord
111 Huntington Avenue
Boston, MA 02199
617.239.0100
www.lockelord.com

Over the last several years, there has been a large increase in the number of municipalities filing for protection from creditors under Chapter 9 of the federal Bankruptcy Code—notably Detroit; Jefferson County, Alabama; San Bernardino, Stockton, and Vallejo, California; and Central Falls, Rhode Island; and Harrisburg, Pennsylvania, which attempted to file for Chapter 9, but was rejected. At the same time, there has been increasing interest in a relatively new type of financing mechanism called "social impact bonds." Query: can the use of social impact bonds be a tool for state, county and local governments to address municipal financial distress?

An Overview of Social Impact Bonds

Impact investing is increasingly recognized by the fields of philanthropy and socially responsible investing as an emerging economy with a powerful potential to leverage investor monies for positive social change. Historically, the federal government has incentivized charitable giving by public and private foundations as well as individuals in the form of tax benefits. With the exception of gifts by charitable corporations, the for-profit sector has, until recently, had relatively few incentives to fund social programming that benefits society's most challenged members.

Social impact bonds ("SIBs") are innovative financing tools whereby government partners with investors (for-profit and non-profit) who provide up-front working capital to fund evidence-based social programs that benefit underserved populations. Such performance-based programs are commonly referred to as pay-for-success programs. Although the terms SIBs and pay-for-success are often used interchangeably, SIBs are a mechanism to finance Pay-for-Success programs. SIBs offer philanthropic entities, corporations, financial institutions and others an investment option with the potential to recoup principal (that, in some cases, would have otherwise been a charitable donation) plus earn a return on the investment.

Contingent social impact investing aligns government, social service providers and investors in a common objective by focusing on proven metrics and outcomes that demonstrate creative problem solving of some of society's most vexing social problems while significantly increasing the efficacy of taxpayer dollars. Under most SIB arrangements, government pays back the principal and a return on investment only if certain pre-defined programmatic milestones have been met, thus transferring risk to the private sector and funding only what works. Government pays for positive outcomes only after they have actually been achieved, instead of paying up-front for programs with an uncertain future benefit.

SIBs are significantly different from traditional municipal bonds. Although SIBs have a fixed term, they do not provide for a guaranteed rate of return. Repayment to investors is entirely contingent, outcome-based, and offers only the potential to profit from the investment. Generally, outcomes demonstrating a larger social impact pay a higher rate of return.

Intervention programs for vulnerable populations that address issues such as recidivism, at-risk youth, and low-income mothers, for example, have been considered the most viable applications for SIBs. Such programs share five main criteria. First, the program needs to have a sufficiently high potential level of social impact so that investors are most likely to realize their desired return. Second, because investors' rate of return is contractually closely correlated to the achievement of certain outcomes, SIBs will only work for programs whose success can be determined with precise and verifiable measurements. Third, the targeted population must be defined up-front, in order to eliminate the possibility of outcome distortion. For example, in a program aimed at prisoner recidivism, the cohort must include all prisoners in a prison community, not just those receiving services. Fourth, a methodology must exist whereby social impact can be reliably measured (in addition to measureable outcomes). Fifth, a contingency plan must be available, in the case of a failed program, so as not to leave a vulnerable population stranded if investors want out.

The first SIB was launched in 2010 by the United Kingdom Ministry of Justice at Peterborough Prison and sought to decrease rates of recidivism among the prison population. Now in its fifth year, investors are on track to receive positive returns in 2016. Since that first experiment, interest in SIBs has expanded quickly, both in the U.S. and abroad.

A (Very Brief) Overview of Tax-Exempt Bonds

Traditionally, public projects have been financed with tax-exempt state and municipal bonds, the income from which is exempt from state and local taxation in the hands of investors. The tax exemption renders investors more willing to accept lower interest rates of return on their investments. The tax exemption, however, represents a revenue loss to the federal government, and therefore Congress and the Treasury Department have implemented laws and regulations imposing requirements that make it quite difficult to issue tax-exempt bonds for projects other than infrastructure, capital projects or short term cash flow. For example, long term working capital financings are discouraged and bonds to finance loans are subject to many restrictions.

How use of SIBs could Assist Financially Distressed Municipalities

Financially distressed municipalities (in fact, all municipalities) need higher revenues and lower expenses. In general, municipalities derive revenues from taxes, fees, assessments and state aid. Their primary categories of expenditures are education, public safety and public services, including services for those in need of public assistance.

One way to increase revenues and decrease expenditures is to increase family incomes of the chronically unemployed or underemployed, including young adults. It goes without saying that higher family incomes would lead to higher income tax and sales tax revenues at the state level, and in those local jurisdictions which collect local income taxes and sales taxes, at the local level as well. In addition, SIBs targeted at programs to provide training, skills and education opportunities for the unemployed and underemployed could benefit distressed municipalities by lowering expenditures for public assistance and public safety, assuming increased employment also results in lower incidences of crime. Such targeted programs could include grants for classes at in-state colleges and junior colleges, keeping funds at in-state institutions.

Tax-Exempt Status for SIBs?

As stated above, current federal tax law and regulations do not permit interest on SIBs to be exempt from federal income taxes. Congress has, from time to time, enacted legislation permitting certain types of facilities and activities to be financed on a tax-exempt basis and should consider providing a tax-exemption on interest income investors receive from SIBs. In contrast to the federal tax-exemption which would require an amendment to Internal Revenue Code, state tax exemptions should be quite simple. In most cases, all that is necessary is a simple statutory enactment by a state legislature stating that SIBs are exempt from state taxation. Federal and state tax-exemptions on SIBs may increase investor appetite and make the social impact programs financed by SIBs less costly, as investors will be willing to accept lower rates of return. Social impact investing is a new type of investing which is still in an evolutionary stage. States considering SIB legislation, as well as the federal government, should consider whether beneficial social impacts will be increased by providing SIBs with an exemption from taxation at both the state and federal level. ●

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