

German discussion paper

Implementing Social Impact Bonds in Germany – Challenges for Pay-for-Success Models in the German Welfare System

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Abstract

The first Social Impact Bond (SIB) in Germany and Continental Europe was implemented from September 2013 to September 2016 in Augsburg, Bavaria. The goal of the SIB named 'Eleven Augsburg' was to find apprenticeship positions or employment for at least 20 disadvantaged adolescents who could not be reached by standard social work measures anymore. All goals set were achieved, and the upfront funding provided by private financiers was paid back together with an interest in line with inflation by the Bavarian State Ministry of Labour, Social and Family Affairs and Integration. Based on a workshop in Augsburg held on the 27th of July 2017 and interviews with representatives from local administrations and involved investors, social service organisations, and the ministry, this paper reflects upon the insights resulting from 'Eleven Augsburg' for implementing SIBs in the German welfare system in general. The findings suggest that SIBs are mainly a tool for developing new ways of addressing social problems, creating networks to this end, and of promoting a culture of evidence-based spending in the welfare system. In this way, cutting public welfare spending can also be achieved, however, this is not the central aspect of the model so far. Main limitations are legal uncertainties perceived primarily on the local level, the complexity of contract design and collaboration between social services organisations, legitimacy issues as well as the need to find efficient impact measurement tools. Based on these findings, the paper suggests ten measures for further advancing the model of SIB in Germany.

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1. Social Impact Bonds (SIBs) – Shifting financial risks to private investors in tackling complex social problems

Social Impact Bonds (SIB) are a relatively new form of channelling private money to the public welfare system to finance innovative projects aimed at addressing social problems. The first SIB was implemented in 2010 in the English city of Peterborough with the purpose of reducing reoffending by young ex-prisoners who have served short custodial sentences. In November 2017, about 89 SIBs were implemented worldwide, most of them in Anglo-Saxon countries such as the UK, the USA, Australia, or Canada¹. The first SIB projects have already been completed by now and provide empirical evidence on their effectiveness and efficiency (Social Finance, 2017).

SIBs follow a payment-by-results logic. In a contract that is usually set up and coordinated by an intermediary organisation¹ a public-sector party commits itself to repay private investors if a certain intervention by social service organisations results in savings in public spending. Additionally, the investors receive a premium for the financial risks they take. If the social outcomes – which are assessed by a neutral evaluator – are not achieved, the investors lose their investment.

In Germany, which traditionally has a strong welfare state with a corporatist tradition (Henriksen, Smith, & Zimmer, 2012), the first SIB was realised between 2013 and 2016 in Augsburg in the federal state of Bavaria. ‘Eleven Augsburg’ was also the first SIB project in Continental Europe. It was initiated by *Juvat gGmbH*, a non-profit subsidiary of the *Benckiser Foundation Future*, which acted as an intermediary, and the *Bavarian State Ministry of Labour, Social and Family Affairs and Integration* (Bayerisches Staatsministerium für Arbeit und Soziales, Familie und Integration (*StMAS*)). Several renowned social service organisations worked with disadvantaged adolescents who had a problematic socioeconomic background² to help them find apprenticeship positions and employment. According to the independent project

¹ Some models also work without an intermediary organisation and the social service organisations directly acquire investors and public partners (Schäfer & Höchstötter, 2015).

² The adolescents exhibited a complete loss of a regular daily structure and of social ties to their families and/or school. Instead, they developed compensatory behaviour involving drugs, violence, or gambling.

evaluator, all formal goals have been achieved, however, there is also room for improvement (Juvat, 2016; Scheck, 2016).

Based on the experiences of this first SIB, this policy paper develops several conclusions for implementing SIBs in the German welfare state. Payment-by-results and impact-oriented public spending are an increasingly important topic on the political agenda; therefore, the learnings from ‘Eleven Augsburg’ are of high relevance. The findings provided in this policy paper are based on a workshop held in Augsburg on the 27th of July 2017 with stakeholders from the social department of the City of Augsburg, the involved job centres, the Bavarian *StMAS*, social enterprises, associations, and research institutions as well as on three follow-up interviews with representatives from involved organisations.

2. Challenges for implementing SIBs in the German welfare system

2.1 ‘Eleven Augsburg’ - Set up and impact of the first SIB in Germany

2.1.1. Partner structure and roles

The ‘Eleven Augsburg’ SIB was realised by a variety of organisations. The upfront financing was provided by three non-profit organisations (*BMW Foundation Herbert Quandt*, *BHF-BANK Foundation*, and *Eberhard von Kuenheim Foundation* of the *BMW AG*) and one social impact investor (*BonVenture gGmbH*). The absence of purely profit-driven private investors could be understood as a sign of a lack of interest which is due to the fact that the risks are high while the returns are expected to be small in Germany, as is emphasised by some experts (Fliegauf et al., 2015). However, the intermediary *Juvat gGmbH* (*Benckiser Foundation Future*) deliberately acquired non-profits as investors to have more flexibility and support in implementing and further developing SIBs as a financing tool. *Juvat* also actively acquired the involved public and social service parties and negotiated and concluded the contractual arrangements between them. The involved social service organisations were *apeiros e.V.* (Wuppertal), *Ausbildungsmanagement Augsburg*, *Kinder-, Jugend und Familienhilfe Hochzoll*, and the *Joblinge gAG* from Munich). The *Bavarian State Ministry of Labour, Social and Family Affairs and Integration* represented the partner

from the public sector and the law firm *Spiegel Rechtsanwälte Wirtschaftsprüfer Steuerberater Partnerschaft mBB* (success) as well as the *University of Hamburg* (process) served as evaluators.

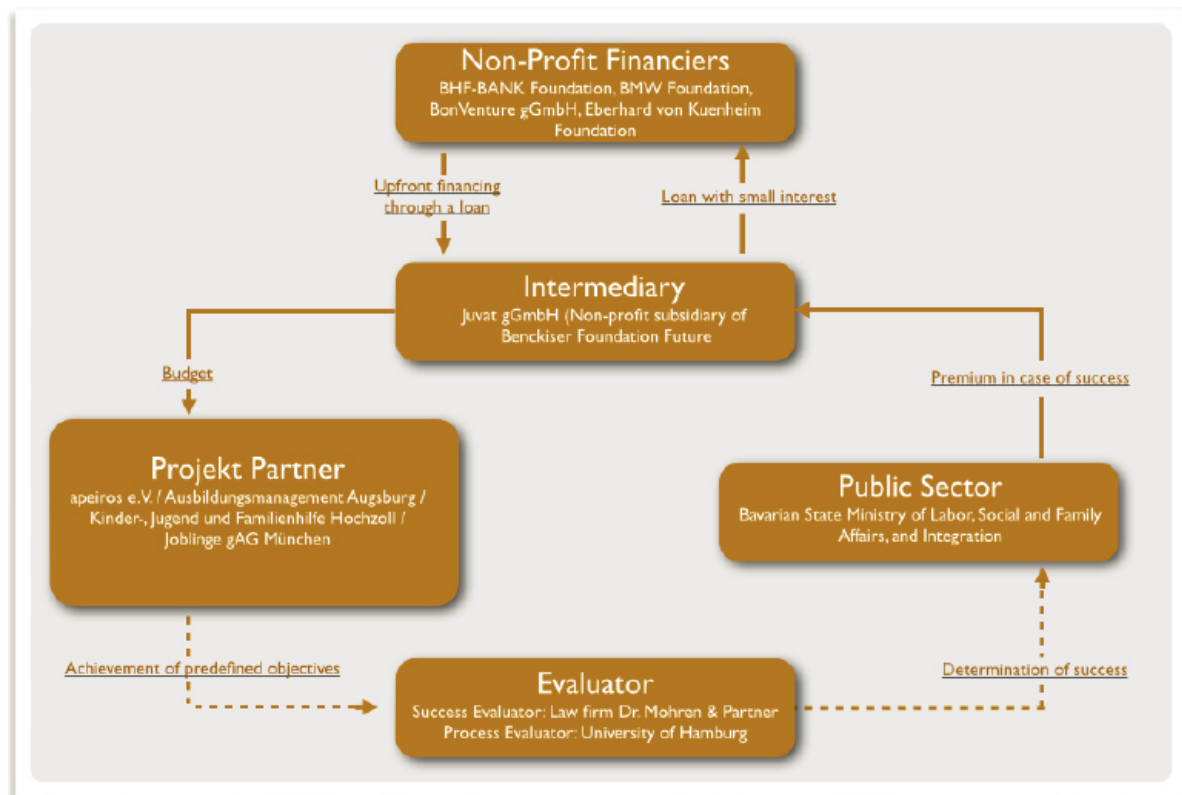


Figure 1: Structure of SIB ‘Eleven Augsburg’ (Juvat, 2016)

2.1.2. Legal aspects

Fliegauf et al. (2015) have identified several key challenges regarding the legal set up for implementing SIBs in Germany. If public bodies are in charge of the field of action, the first challenge is which of the financing instruments provided in the German Social Code (Sozialgesetzbücher, SGB) to apply. One option is public funding in accordance with public law (öffentlich-rechtliche Zuwendung). The German Social Code regulates the legal rights of individuals in specific fields, for instance youth welfare, where the youth welfare office pays the services provided by social services providers; in this case it must be demonstrated beforehand that this multi-stakeholder arrangement involving an intermediary and an evaluator is necessary to

generate impact for the intended target groups (principle of subsidiarity underlying the SGB). Moreover, public bodies usually do not cover the full costs of services that go beyond the basic supply (principle of subordinate und complementary public financing). This makes it difficult to justify the full coverage of costs plus the abovementioned premium after a SIB has been successfully completed. The other model the Bavarian *StMAS* opted for is a service agreement under civil law (zivilrechtlicher Leistungsvertrag) between the public body and the intermediary. The latter then makes sub contracts with the investors and the social services organisations. Within the framework of this option, the contract defines relatively clearly the results that have to be achieved, duties such as information obligation and permit requirements, and the payment mechanism. For the social services provided in SIBs, however, the contract leaves a high degree of flexibility. While in both options the public partner is the entity which has the decision-making authority regarding what social issues and target groups are to be addressed, in the latter option the influence of the public partner is even bigger, and a considerable amount of negotiation is required (see below). According to the principle of economy, the selection of an intermediary would require a tendering procedure. In the case of ‘Eleven Augsburg’, however, the philanthropic intermediary did not charge any fee for the provided services, with the result that it was not necessary to meet this requirement.

The second legal challenge is the budgetary treatment of SIBs (Fliegauf et al., 2015). The German budgetary law requires that potential savings arising from a novel mechanism be demonstrated *ex ante* (principle of economy), which the ‘Eleven Augsburg’ network achieved in collaboration with the Court of Auditors. For SIBs, a funding commitment for a period of several years is necessary, which is generally difficult to get. This can be even more difficult when SIBs are supposed to be implemented across more than one legislative period, at least in some federal states. ‘Eleven Augsburg’ was realised during the legislative period between 2013 and 2018, although the corresponding negotiations had started earlier.

The third legal challenge is the German law on foundations (Fliegauf et al., 2015). It requires a risk-averse investment strategy with preservation of the capital endowment. This makes mission investing in SIBs, i.e. investments within asset management, difficult because of the SIBs' considerable risk of default. The other option are investments from operational resources, which, however, may conflict with the restrictions on commercial business activities. In 'Eleven Augsburg', the foundations involved used both opportunities.

2.1.3. Evaluation and impact

The impact of 'Eleven Augsburg' was evaluated in two different ways. Firstly, the law firm *Spiegel Rechtsanwälte Wirtschaftsprüfer Steuerberater Partnerschaft mBB* (Munich) evaluated the success of the SIB. The aim of the project had been to provide at least 20 adolescents with a disadvantaged socioeconomic background with an apprenticeship position or employment that would last at least nine months (Juvat, 2016). This goal was achieved. In total, about 100 adolescents had been approached by the social service organization, and 69 were included in the program. A more detailed assessment of methodological issues and key challenges of the evaluation process is difficult based on the data provided.

In addition, aspects such as the motivation and goals of the partners, the collaboration process, financing procedures, or programme design of the 'Eleven Augsburg' SIB were evaluated by the University of Hamburg (Scheck, 2016). Based on semi-structured interviews with all relevant actors, the evaluation found, for instance, that – in opposite to Anglo-Saxon models – an improvement of service quality for the beneficiaries was more important than cost savings for the involved institutions and organisations. Further, the project partners appreciated the flexibility to adjust a previously defined impact chain, i.e. the way the intermediary had planned for the partners' services to complement each other over time. The same holds for the focus on goals instead of technical conditions for interventions, since dependencies and interrelations in this new field had to be explored first. However,

the project partners were critical about the selection process, design³, and interpretation of the goals. Starting the project, they also had different impressions about the feasibility of the goals in the given time and with the budget which they perceived as rather low. Service organisations as well as investors emphasised the high transaction costs in such a multi-stakeholder pilot project. The evaluation also found that the best way to identify and access the adolescents to be addressed by the SIB was the 'recommendation' on the part of their peers. Those adolescents who left the programme did so because the requirements of the working context⁴ were too demanding for them. Regarding investor interests, the evaluation showed that the 'Eleven Augsburg' SIB was a more attractive alternative compared to grants provided by foundations and not so much for investment provided by impact investors.

2.2 Opportunities through implementing SIBs

Workshop participants and interview partners agreed that SIBs provide several opportunities for achieving a positive impact by addressing social problems. Some of them are common in the discussion about SIBs, whilst others go beyond the direct goals of single projects.

2.2.1. Promoting innovative social services for hard-to-reach beneficiaries

SIBs allow to help people who are hardly or not at all reached (any more) by standard social security measures, education, and the apprenticeship system. In Augsburg (about 286,000 inhabitants), the project partners estimated the size of this target group at 300 to 450 adolescents⁵ (Scheck, 2016). SIB enable social service organisations to intensely work with these adolescents with whom schools, regular youth welfare institutions, or job centres can hardly cope. It is necessary to constantly and intensely work with these young people to overcome factors that erode their

³ For example, the last chance to find an apprenticeship position or employment for the adolescents was April, whilst most companies conclude apprenticeship contracts in September or October.

⁴ About 30 per cent of the dropouts participated in other programmes afterwards.

⁵ Social service organisations estimated that two thirds of the adolescents would have been reached by 'regular' measures at a certain point. According to their estimation, from the remaining third about 30 per cent cannot even be reached by means of the SIB.

motivation to return to the labour market and a regular working life. What is more, the focus of the SIB has increased the understanding of this specific target group (Scheck, 2016). Workshop participants confirmed the impression of the evaluation that the relatively flexible budgets without high bureaucratic obligations can more easily enable innovative approaches (Scheck, 2016). Fliegauf et al. (2015) suggest that vulnerable families and children (developmental disorders, child endangerment), juveniles (criminality), marginalised populations (no school-leaving qualifications, no language skills), or those in need of care as well as people with psychological disorders can be further beneficiaries of SIBs.

2.2.2. Initiating social innovation networks

Social service organisations as well as beneficiaries benefited from the collaboration within the SIB, mainly through the exchange about methods and the joint reflection on beneficiaries or certain measures in some cases (Scheck, 2016). Furthermore, SIBs can be an effective instrument to implement new networks of people and organisations in the field of social innovation. Set up as a multi-stakeholder arrangement, SIBs bring together representatives from social service organisations, public administration, investors, foundations, and consulting firms. These representatives are usually innovators who want to advance funding mechanisms for addressing social issues in general, hence they are usually involved in a variety of projects. Therefore, the SIB-related networks grow beyond the context of an individual project and promote creative solutions also in other contexts. For the organisations involved, these networks can also be an asset to pursue their own mission in the local context, as a project partner stated in the workshop. Moreover, the marketing effect and the public attention given to an SIB project can bring considerable benefits.

2.2.3. Promoting a culture of evidence-based spending for public welfare

Workshop participants from the local administration level reported that evidence-based funding schemes which follow a payment-by-results logic are extremely hard to implement for them. This fact inhibits particularly the diffusion of preventive approaches to social issues, since these do not provide incentive structures for administrations which are responsible for the financial planning and in this case, do not derive any particular benefit from saving money. The implementation of SIBs and similar models, however, can provide the ground for such approaches. SIBs initiate a reflection on how impact can be assessed and what tools and structures are necessary for this. Further, they allow for learning how evidence can be included in decisions about resource allocation.

2.2.4. Cutting public welfare spending

Even though ‘Eleven Augsburg’ does not explicitly focus on cutting public welfare spending, SIBs offer a chance to reduce public spending at least in the long run also in the German welfare system, as the results of the evaluation indicate. This, however, would require to fully exploit the insights gained from SIBs about social services design, on the one hand, and about evidence-based funding schemes and administrative issues, on the other (see also chapter 3. Conclusions). For the project partners, the effort connected with gaining insights and learning from SIB projects is still relatively high due to the lack of experience and structures as well as because of legal uncertainties. For the SIB mechanism to succeed in the long run, however, a benefit for all involved actors must be achieved.

2.3 Limitations in implementing SIBs

The experiences gained from ‘Eleven Augsburg’ and the workshop results confirmed that there is a variety of limitations which today inhibit the diffusion of SIBs in Germany.

2.3.1. Legal uncertainty due to unsuitable regulatory frameworks for SIBs

A key challenge is the legal treatment of SIBs. Representatives from different local administrative bodies stated that from their perspective SIBs would violate several basic principles of social law. In general, local representatives seem to judge their possibilities to be more restricted in comparison to the federal state level. Uncertainties regarding the legal treatment of SIBs are of greater importance here, with the result that there are even concerns about personal liability. In comparison to this, SIBs were not considered as attractive enough to invest the extra administrative effort and clarify relevant issues by most local level administration representatives.

2.3.2. Contract design and verification of preconditions

The design of a SIB contract is a rather legal and conceptual problem. For instance, it defines the preconditions which the addressed beneficiaries must fulfil or the goals determining the success of the SIB. The evaluation of the process has already shown that a precise and thoughtful definition of goals is difficult (Scheck, 2016). This may be immanent in new fields or ways of intervention up to a certain point. As one workshop participant stated, it is also difficult to verify whether the adolescents to be addressed have indeed dropped out of the system; for example, if they do not have a passport anymore, it requires much effort to clarify whether they really have not acquired a school-leaving qualification in another country. However, contract design is key for the SIB mechanism to work.

2.3.3. Interfering approaches and interpersonal tensions in collaboration solutions

Within SIBs, usually several social service organisations work together on a complex issue. This is also a core challenge for SIBs. The social service organisations' solution approaches – especially if they pursue highly innovative approaches – can somehow interfere with each other, with the result that responsibilities can be unclear and even interpersonal tensions can arise. For example, if one social enterprise has defined a different alternative path to obtaining a school-leaving qualification than

another social enterprise, their approaches may not be fully compatible. Further, a tight budget can lead to an increased rivalry between the social enterprises. The impression gained from 'Eleven Augsburg' was that the competences of one social service organisation may have been sufficient for the task to be performed, however, it would not have had enough capacity to fully cover the entire target group of the SIB in Augsburg (Scheck, 2016).

2.3.4. Legitimacy issues (in case of failure)

As many investment-based financing instruments for social issues, SIBs are sometimes confronted with the allegation that they turn social needs into a question of economic profitability or that the demand to achieve returns reduces the quality of social services due to cost cutting. This argument overlooks important aspects, for instance the fact that foundations which aim at enhancing innovative approaches by means of mission-related investments in SIBs take a risk. These investments have to be reasonable in relation to the mission these foundations pursue by means of the generated returns; therefore, adequate returns are important. In general, legitimacy issues often seem to be a communication problem that may be overcome through more transparency. Apart from this common issue, also another question was raised in the discussion, namely: How do stakeholders react if a SIB fails and the money that has obviously been budgeted by the public administration for it is freed up, from the perspective of outsiders from other fields? This is another question that can be examined in more detail only through future experiences with SIBs.

2.3.5. Impact measurement

In the context of SIBs, the measurement of their impact and the efforts connected with implementing them represent another key challenge. The discussion revealed the tension between simple performance indicators that are easier to obtain and more accurate results that justify public spending. According to one of the SIB organisations, a key insight was that impact measurement should be performed by an entity which is familiar with the social security and youth welfare system in

Germany. These organisations fear that the situation may be more complex in Germany because of the principle of economy and efficiency (Prinzip der Wirtschaftlichkeit und Sparsamkeit) which applies to the job centres and the social service administration. This implies that the results of the SIB have to be calculated beforehand and must demonstrate its better cost-benefit relation in contrast to other solution approaches.

3. Conclusions

Insights from the first German SIB 'Eleven Augsburg' suggest that SIBs are a tool for developing new solutions to address social problems, to reach difficult target groups, and to create social innovation networks. However, from today's perspective it is most likely that SIBs will not become a broad-scale financing instrument on a local level due to their great complexity, transaction costs, and further already mentioned problems. However, SIBs have the potential to become a development tool for the subsidiary and communitarian German welfare system, in which public partners can exert a certain influence from the beginning. To improve the functioning of SIBs, there is variety of measures that can improve the acceptance and implementation of further SIBs. Such measures include:

Creating legal security: One of the main problems connected with SIBs is legal uncertainty. In the German Social Code (SGB), innovative measures are not really considered yet. Adding a clause in the SGB regulating the funding of innovative approaches such as SIBs could provide a more solid basis for negotiations in the future (Oetztuerk, 2013). Clarification is also needed as to the mentioned uncertainties in the law on foundations. Another approach is to find and share clear mechanisms under the current legal framework. For instance, if a philanthropist acts as an intermediary and does not charge any fee for his or her services, it is unlikely that the public entity has to set up a tendering procedure for a civil law service contract.

Providing a long-term perspective for SIBs: Through SIBs, the participants gain new knowledge for solving social problems, both regarding financing issues and the actual social service. To benefit from this knowledge in a sustainable way, it should also be used after a SIB phase has terminated. One option would be to provide a subsequent funding phase and to efficiently use and improve established structures to this end. In this way, SIBs could be prolonged over a period of several legislative periods in all federal states, possibly with different investors. Another possibility would be to mandatorily examine how the developed solution approach can be integrated into the regular funding schemes of social services. Thereby, however, the flexibility of the SIB solution has to be maintained.

Developing the SIB model towards more flexibility: So far, SIBs have an all-or-nothing design. However, to reduce the risk for investors, the objectives could be achieved gradually. This means that private investors would receive money back according to different thresholds displaying the cost saving for the public partner. This would reduce the risk for investors and thus most likely also the transaction costs of finding partners. There are also further models that involve public and private investors. For example, in Social Impact Incentives (SIINC), a public funder remunerates social service organisations which have achieved a proven impact in order to enable them to access private investments.⁶ Combinations with crowdfunding might also be an option worth further examination.

Providing SIBs with sufficient resources: SIBs usually work in a pioneering mode and thus usually include highly motivated social service organisations. Some pressure to achieve a certain goal can also help increase efficiency and effectiveness in pursuing this goal. However, SIBs must not become an instrument provoking self-exploitation. A too tight budget combined with a fixed goal can create an incentive structure leading in this direction.

⁶ <http://www.roots-of-impact.org/siinc/>

Choosing a reasonable number of partners. One or two social service partners may be more efficient than three or four, at least if there are no established regular work relations. Otherwise the transaction costs might be too high. Yet, it is also important that the organisations can provide enough capacity for the work in the SIB, which usually goes with flexible multi-instrument approaches.

Considering SIB budgets on the (federal) state level: If SIBs remain a tool to test new and innovative approaches and do not become a tool for regular financing, it makes sense to set up a budget for financing innovations that is not assigned to a certain field of activity. Such budgets could exist at the federal state or national level and could be used to guarantee that private investors on the local level are paid back the money they invested, if the SIB results in success. In addition, it would be easier for the local administrations to make balancing payments to other public entities.

Providing seed funding for SIBs on a local level: As many workshop participants stated, their workload does not allow them to examine the complexity of a social impact bond in more depth. Through seed funding provided either by the intermediary or the investors, or by a public entity, personal and/or financial resources could be allocated especially to local administrations. To set up SIBs, these resources could be used for the research on legal issues, questions related to resource allocation, negotiations, etc. If a SIB is successful later on, this investment can also be repaid to the investors.

Increasing transparency and ‘learning culture’ in connection with SIBs: Findings about key indicators that resulted from the SIB project in Germany have been shared by the involved intermediary and the *Bavarian State Ministry of Labour, Social and Family Affairs and Integration* only superficially, while there was some more information about procedural issues. In general, the public communication of the successful SIB was relatively poor. By increasing the promotion of SIBs and the transparency regarding the related positive and negative experiences, it could be

possible to establish a better 'learning culture' in connection with public financing tools such as SIBs. This might also be supported by qualitative evaluations in addition to financial figures, as the SIB participants have stated (Scheck, 2016).

Targeting more specifically impact-first investors for SIBs: There is still a tendency to argue that in the long run SIBs can also represent an attractive investment for financial institutions, pension funds, or insurance companies. However, at this point the cost and risk structure indicates that SIBs are an option for impact investors who accept returns on their investments below the regular market level in favour of the social impact that is created. Such impact investors can be foundations, high-net-worth individuals, or companies with a CSR budget; they, at least, should be the main partners participating in the learning processes connected with pioneering SIB projects.

Developing efficient impact measurement tools for SIBs: Crucial for the SIB model to work reliably are evaluation and impact measurement. To perform them in an adequate manner, often a detailed knowledge of the legal environment is necessary; thus, resources can be saved if the evaluator has the necessary knowledge in the field in question. However, there is also a need for expertise in impact measurement procedures and even more for further development of efficient tools to provide it.

Social impact bonds are clearly an instrument that is worth further examination, and for solving the related issues, more experience with this model is essential. New bonds such as the recently launched SIB in the region of Osnabrück are a good step in this direction.

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