How social impact bonds put private profit ahead of public good

BY Mark Rosenman *February 19, 2014 at 2:09 PM EST*

Editor's Note: Last spring, Making Sense asked what Goldman Sachs, Rikers Island and a private charitable foundation could possibly have in common. As we explained in a two-part series, which you can watch below, they're all part of a new private-public partnership working to reduce recidivism in New York City.

In the "social impact investing" model, private investors lend to a social service nonprofit with a successful track record. The nonprofit uses the loan to expand their programming, while the investors receive an interest-paying bond in return. Payout of the bond is based on the outcome of the nonprofit's programming.

And here's where the third player in this triangular investing model comes into play. A key part of the social service's success is saving taxpayer dollars. In New York City, for example, Goldman Sachs and the Rockefeller Foundation invested in the Osborne Association's cognitive behavioral therapy program for young offenders at Rikers Island, with the hopes of breaking the cycle of recidivism and keeping young people from returning to jail. Reducing repeated incarceration should save the city money, and so it's with that money that the city would be expected to pay back the investors' loan.

As the Rockefeller Foundation's Judith Rodin explained in our first segment, the model is a win for everyone involved, including government and the taxpayers.

But what if it's not? Mark Rosenman, professor emeritus at the Union Institute & University, was our skeptic in both stories.

Mark has returned now to Making Sense arguing that social impact investing is getting much more glory than it deserves.

But first, an update on the Rikers Island program. The New York City Department of Correction says they won't know about the program's effect on recidivism until 2015. But they report that, as of December, fights among the adolescents are down 36 percent and uses of force are down 27 percent since Osborne's therapy program went to scale in January 2013.

Next, we'll hear from Social Finance's Jane Hughes and Alisa Helbitz, who have championed social impact investing. Goldman Sachs declined to respond.

Not long ago, New York City and Goldman Sachs began to experiment with a new financial instrument — social impact bonds (SIB) — to reward private capital for financing a nonprofit program that might otherwise have been passed over for municipal funding.

There has been some excitement about this notion, as deficit-strapped governments, underfunded charities and too-limited foundations see a potential new source of program dollars, especially one rife with sanctified market aphorisms.

Unfortunately, the SIB model is being touted much more broadly as the next best thing without any critical examination of the assumptions behind it or the funding crisis which drives it.

What, for example, would happen if taxes were cut to the point that government is hard pressed just to fund defense, public safety, entitlements and its own operations, and so has to turn to private investors who demand a profitable return to finance critical public infrastructure and nonprofit services? If some have their way, we're likely to find out.

In fact, we've already begun to face exactly that situation. Over 57,000 children have lost Head Start services because of tax cuts and the sequester while Goldman Sachs has launched a "social impact" investment fund to provide private capital as an alternative to public funding for early childhood education and for many other nonprofit program areas experiencing government shortfalls.

We know Head Start saves government at least $7 for every dollar spent on it. If Goldman and Morgan Stanley have their way, we'll soon have to pay them and their clients a portion of those savings for having replaced taxpayer funding for such programs with private capital investments.

Let's call it what it is: private profit crowding out a public good. But how did we get here?

Conservatives' agenda has long been to reduce taxes in order to benefit the wealthy while also compelling a reduction of services for most of us. As right-wing activist Grover Norquist — the force behind politicians' anti-tax pledge — famously said, "I don't want to abolish government. I simply want to reduce it to the size where I can drag it into the bathroom and drown it in the bathtub."

Rather than see government gather and allocate tax revenues for nonprofit programs and other services, conservatives (at least the compassionate ones) used to prefer a return to alms, to voluntary philanthropic donations to help meet public needs. In fact, while he was running for president, Mitt Romney argued that charitable contributions were the equivalent of taxes, a position supported by the libertarian Cato Institute and others.

Yet, where conservatives formerly might have seen charity, Goldman Sachs and Morgan Stanley now see new profit centers. While they try to reduce or completely avoid the taxes which they

and their clients might otherwise pay, they both have launched funds for investors to make a profit by replacing government funding for nonprofit programs.

This shouldn't be a surprise. A couple of decades ago, when the nonprofit sector approached 5 percent of GDP, it was clear that the market would eventually find ways to peel off the potentially more profitable areas of charitable activity. First it was nonprofit health care, with everything from medical insurance programs to hospitals and clinics being converted to for-profit status. Next came higher education — colleges, universities and vocational schools were acquired by, or started up by, for-profit corporations.

While these were by far the largest, most obvious and lucrative targets for profit-seeking investors, one had to wonder how long other program areas such as human services and anti-poverty efforts would be spared the seeming imperatives of capital. One need wonder no longer.

Goldman, with the blessing of Bloomberg Philanthropies, pioneered the SIB concept here in the United States and is already asserting, without any evidence, that it will achieve positive outcomes for the participants in a municipal prison-based nonprofit program designed to reduce recidivism among the city's juvenile offenders — and save the government money.

To be clear, that program and a host of others that might be financed through such "social impact investing" quite likely will produce salutary outcomes, and the nonprofit organizations that offer them are increasingly desperate for dollars in the face of government cut-backs and short-falls. But the question our society must face is *how* we wish to fund these efforts.

Where is the wisdom in developing new investment opportunities that further enrich the wealthy and financial institutions while costing government much more than if programs were funded with tax dollars or even through interest-bearing government bonds (which likely would cost well under half of what these profit-seeking social investments are projected to yield, and which Goldman's executives refuse to cap).

Don't citizens have a reason to be suspicious when those most likely to profit from these new social investment schemes are the ones creating the financing imperative by working to reduce the tax revenues that would otherwise fund the programs in question? The same people, in fact, who in many cases are pushing to create tax breaks for these investment schemes themselves.

Although Goldman's CEO Lloyd Blankfein claims to be in favor of increased taxes, he arranged for the early distribution of $65 million in stock to himself and his top colleagues so that they could avoid a new higher tax rate. If Goldman, Morgan Stanley and other financial institutions are truly concerned about financing much-needed social programs, why don't they give up their prodigious tax avoidance and new financing schemes and instead support a Wall Street sales tax that would raise hundreds of billions of dollars each year for public purposes?

While they're at it, why don't they support reforms that prevent Nike, Apple, Microsoft and other multinationals from using offshore tax havens to stash their profits and from avoiding paying over $90 billion in taxes that would otherwise flow to the Treasury? For that matter, another 235 companies have parked more than $1.3 trillion more in profits abroad, thereby

avoiding U.S. taxes on those profits. The practice is so ingrained that when former Senate Finance Committee chair Max Baucus, D-Mont., offered doing away with it as a tradeoff for reducing corporate tax rates, business lobbyists threw a fit.

In fact, the share of federal tax revenue from corporations has fallen by two-thirds since the 1950s as a result of loopholes and corporate tax breaks; their actual taxes have dropped to about 10 percent since the recession although their profits doubled in less than 10 years.

Many individuals also subscribe to the concept of tax avoidance — including the more than 35,000 wealthy American households that paid no income tax at all in 2009 (the most recent year for which complete data is available). If they and individuals subject to the so-called "Buffett Rule" — a proposal to apply a minimum marginal tax rate of 30 percent on individuals' income over a million dollars each year — truly wanted to advance the public good, they would support the administration's proposal, resulting in an additional $40 billion in tax revenue over the next 10 years. That's more than four times the amount that Goldman and Morgan Stanley together hope to leverage through the nascent "social impact" industry.

Yes, there are things to like about impact investing, including its clear focus on outcomes and the idea that more of us should be paying attention to social and environmental problems.

But the actual implementation of these financing schemes is not without problems — such as the difficulty of accurately assessing positive social outcomes and appropriately attributing them to funded intervention programs; the tendency to conflate "paying for success" and related concepts only with programs that are so financed; the focus on remediation at the expense of prevention; and creating ways of profiting a new industry of wealthy intermediaries.

Still, the fundamental problem with all of these schemes is the question of how we as Americans wish to meet and fund public needs.

Do we really want to provide funding for critical public goods only when it puts money in our pockets, or do we want to preserve and even strengthen the idea that we together have a collective obligation to provide the tax revenues that pay for those services, advance the common good and benefit ourselves and one another? Is seeking a financial return for ourselves more "American" than working together through government, nonprofits and philanthropy to serve the neediest among us, as well our own communities and the general public?

Can there to be any realm of our national life where the market doesn't rule, where we agree to put public good ahead of private profit?