

Social Impact Bonds: Lessons Learned So Far

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Although Pay for Success (PFS) contracts have received widespread attention in the United States and abroad, there is nothing fundamentally new about governments paying for outcomes. Performance clauses in construction contracts are common, and the Department of Defense has procured services using performance-based contracting for years. Many state and local governments now use performance clauses in their procurement of human services, for example by providing bonuses to contractors administering job training programs based upon the number of clients who obtain and/or retain jobs.

What makes recent PFS initiatives distinctive is that they are focused not simply on creating additional financial incentives for contractors to produce better outcomes, but more broadly on overcoming the wide set of barriers that are hindering the pace of social innovation. For sure, these barriers include a lack of performance focus and outcome measurement, but they also include political constraints that prevent government from investing in prevention, the inability of nonprofits to access the capital needed to expand operations, and insufficient capacity to develop rapid and rigorous evidence about what works. In some of these new models, the amount of performance risk shifted from taxpayers to those on the hook for producing the outcomes is much greater than under traditional performance contracts, requiring the participation of socially-minded investors to make the projects feasible.

The social impact bond (SIB) is one of the new approaches to financing social innovation. Under the most common SIB model, the government contracts with a private-sector intermediary to obtain social services. The government pays the intermediary entirely or almost entirely based upon achievement of performance targets. Performance is rigorously measured by comparing the outcomes of individuals referred to the service provider relative to the outcomes of a comparison or control group. If the intermediary fails to achieve the minimum performance target, the government does not pay. Payments typically rise for performance that exceeds the minimum target, up to an agreed-upon maximum payment level. Payments are funded at least partially by the cost savings to government achieved through the improvement in outcomes.

The intermediary obtains operating funds by raising capital from independent commercial or philanthropic investors who provide up-front capital in exchange for a share of the government payments that become available if the performance targets are met. The intermediary uses these operating funds to contract with service providers to deliver the interventions necessary to meet the performance targets.

For the past two years, the Harvard Kennedy School's Social Impact Bond Technical Assistance Lab (SIB Lab)¹ has provided pro bono technical assistance to several state and local governments as they have developed SIB initiatives. This hands-on involvement informs our research on how governments can foster social innovation and improve the results they obtain with their social spending.

This article describes some of the lessons we have learned about SIBs from our work, focusing in particular on topics where our thinking has changed since our initial analysis of the model.² It also describes what we see as the key unanswered questions about the future of the SIB model.

Social Impact Bonds Are Spreading Faster Than Expected, Both in the United States and Abroad

Following the announcement of the world's first SIB in the United Kingdom in 2010,³ countries as varied as Australia,⁴ Canada,⁵ Columbia,⁶ India,⁷ Ireland,⁸ and Israel⁹ have started exploring SIBs. Proposed projects target social problems ranging from recidivism to homelessness,¹⁰ unemployment,¹¹ youth outcomes,¹² and early childhood education.¹³

In the United States, interest in SIBs continues to spread rapidly. Funding for PFS contracts was proposed in President Obama's February 2011¹⁴ and 2012 budgets,¹⁵ and a

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- 1 The authors are grateful to the Rockefeller Foundation for financial support. For more information about the Harvard Kennedy SIB Lab, see www.hks-siblab.org.
 - 2 Liebman, Jeffrey B. "Social Impact Bonds: A Promising New Financing Model to Accelerate Social Innovation and Improve Government Performance." Center for American Progress, February 2011.
 - 3 Ministry of Justice/Social Finance, "Minister Launches Social Bond Pilot," September 2010, available at www.socialfinance.org.uk/sites/default/files/SIB_Launch_PR.pdf.
 - 4 Centre for Social Impact, Australian School of Business, "Report on the New South Wales Social Impact Bond Pilot," February 2011, available at www.csi.edu.au/assets/assetdoc/0b6ef737d2bd75b9/Report_on_the_NSW_Social_Impact_Bond_Pilot.pdf.
 - 5 Human Resources and Skills Development Canada, "Government of Canada Involvement in Social Finance," November 2012, available at www.hrsdc.gc.ca/eng/consultations/socialfinance/goc_involvement.shtml.
 - 6 Instiglio, "Adolescent Pregnancy in Colombia," available at www.instiglio.org/the-innovation/projects/.
 - 7 Instiglio, "Gender Gap in Education in India," available at www.instiglio.org/the-innovation/projects/.
 - 8 Clann Credo—the Social Investment Fund, "Research to Identify High-Potential Social Impact Bond Areas in Ireland," April 2011, available at www.clanncredo.ie/default.aspx?m=30&mi=217.
 - 9 The Portland Trust, "Innovative Financing to Deliver Sustainable Funding for Israel's Social Sector," 2012, available at www.portlandtrust.org/projects/financial-infrastructure/social-investment-and-social-finance.
 - 10 Commonwealth of Massachusetts, "Massachusetts First State in the Nation to Announce Initial Successful Bidders for 'Pay for Success' Contracts," August 2012, available at www.mass.gov/anf/press-releases/fy2013/massachusetts-first-state-in-the-nation-to-announce-ini.html.
 - 11 San Diego Workforce Partnership, "Board of Directors Agenda Item 10: Pay for Success Grant Procurements," October 2012, available at http://workforce.org/sites/default/files/pdfs/agendas/10-03-12_bod_agenda.pdf.
 - 12 Ready by 21, "Using Social Impact Bonds to Support a Bundle of Youth Interventions," May 2012, available at www.readyby21.org/resources/webinar/using-social-impact-bonds-support-bundle-youth-interventions.
 - 13 David W. Chen, "Manhattan Borough President Seeks Bonds to Expand Early Education," *New York Times*, October 15, 2012, available at <http://www.nytimes.com/2012/10/16/nyregion/manhattan-borough-president-seeks-bonds-to-expand-head-start.html>.
 - 14 Office of Management and Budget, "Fiscal Year 2012 Budget of the US Government," available at www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf.
 - 15 Office of Management and Budget, "Fiscal Year 2013 Budget of the US Government," available at www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf.

grant solicitation is currently in progress from the US Department of Labor that would fund up to \$20 million of PFS contracts to improve employment and training outcomes.¹⁶

New York City established the first SIB in the United States.¹⁷ The initiative provides services to 16- to 18-year-olds who are jailed at Rikers Island and aims to reduce recidivism and its related budgetary and social costs. Services are being delivered to approximately 3,000 adolescent men per year from September 2012 to August 2015. MDRC, a prominent nonprofit research organization, serves as the intermediary, overseeing day-to-day implementation of the project and managing the two nonprofit service providers who are delivering the intervention. Goldman Sachs is funding the project's operations through a \$9.6 million loan to MDRC. The city will make payments that range from \$4.8 million if recidivism is reduced by 8.5 percent to \$11.7 million if recidivism is reduced by 20 percent. Bloomberg Philanthropies is guaranteeing the first \$7.2 million of loan repayment.

Meanwhile, Massachusetts and New York State are working to become the first state governments to enter into PFS contracts using SIBs. In January 2012, Massachusetts launched procurement processes to obtain intermediaries and providers for two SIB projects, and it announced the selection of those partners in August 2012. The first project will serve 900 youth over three years who are aging out of the juvenile justice system and expects to produce budget savings from reduced incarceration costs. The second project aims to house 400 chronically homeless individuals over a three-year period and expects to produce budget savings from reduced Medicaid spending. In July 2012, New York State began the procurement process to seek an intermediary to help set up a PFS project that would offer transitional employment services to adults released from state prisons.

Recently, the Harvard Kennedy School SIB Lab requested applications for additional US jurisdictions to assist. Twenty-eight state and local governments applied.

Why are so many governments interested in SIBs? SIBs offer an answer to a question all policy makers are facing in these difficult fiscal times: How do we keep innovating and investing in promising new solutions when we can't even afford to pay for everything we are currently doing? SIBs also align well with the spread of data-driven leadership practices focused on improving government performance and with government efforts to collaborate with nonprofit and for-profit partners in solving community-based problems.

Several Different Model Variations Are Starting to Emerge

The SIB model requires specific tasks to be completed by the government's private-sector partners. These include raising capital to fund operating costs and absorb risk, assembling a team of service providers, and managing the team to achieve performance objec-

16 US Department of Labor, "ETA Solicitation for Grant Applications: SGA/DFA PY 11-13," May 2012, available at www.doleta.gov/grants/pdf/pfs_sga_dfa_py_11_13.pdf.

17 Mike Bloomberg, "NYC Announces Nation's First Social Impact Bond Program," August 2, 2012, available at www.mikebloomberg.com/index.cfm?objectid=E791E137-C29C-7CA2-F5C2142354A09332.

tives. In the original Peterborough SIB project in the United Kingdom,¹⁸ the intermediary, Social Finance, is at the center of the transaction, performing all three roles and holding the contract from the government. However, other structures are also possible. For example, the government could contract directly with a lead provider, and that provider could raise funds from philanthropists and subcontract with additional providers. In that case, intermediaries might serve as consultants to the lead provider, helping the provider build its capacity to raise funds and meet performance targets. It is also possible that a foundation with an interest in testing solutions for a particular social problem might assume the lead role in negotiations with the government and then hire staff to manage the project and recruit providers.

For a UK job creation initiative, the ethical investment group Triodos Bank took the role of lead advisor and made all the arrangements for a foundation, a private investor, and a social enterprise to enter into a PFS contract.¹⁹ In Minnesota, legislative authority has been obtained for a human capital bond approach under which the state will issue new debt in order to finance preventive investments.

Given that SIBs remain experimental, the emergence of multiple models is promising since we do not yet know which models will work best, and it is likely that different structures will be most effective in different circumstances.

The Most Important Criterion for Deciding Whether to Establish a Social Impact Bond: Impact

When we wrote our initial paper on SIBs in 2011,²⁰ we identified five key criteria that a project must satisfy to be appropriate for a SIB: sufficiently high net benefits to allow both taxpayers and investors to come out ahead; measurable outcomes; well-defined treatment populations; credible impact assessments; and safeguards against harming the treatment population. After experiencing the complexity involved in developing SIB projects, we now believe the most important criterion for deciding whether to do a SIB is its potential for a large impact.

Establishing a SIB takes sustained attention over the course of a year or more from top officials in the state, county, or city implementing them. Given the other demands on these officials' time, an initiative is only worth undertaking, and only likely to succeed, if it is directly aligned with one of the governor's, county executive's, or mayor's top priorities. To be worth the effort, SIBs require either a large initial scale or a realistic vision for scaling up an initial successful SIB into a larger (e.g., statewide) initiative. Or they need to be aligned with a broader performance or reform agenda in such a way that a successful SIB has spillover benefits into an important area of existing spending.

18 Social Finance, "Peterborough Social Impact Bond," 2011, available at http://socialfinanceus.org/sites/socialfinanceus.org/files/SF_Peterborough_SIB_0.pdf.

19 Andrew Holt, "Triodos Raises Social Impact Bond for New Social Enterprise," *Charity Times*, November 2011, available at www.charitytimes.com/ct/Triodos_raises_Social_Impact_Bond.php.

20 Liebman, *Social Impact Bonds*, February 2011.

Initial Projects Contain More Innovation and Learning and Less Replication Than Anticipated

Initially, we expected the first applications of the SIB model to involve replication and scaling of proven interventions. However, experience has shown that rigorously proven models do not exist for most of the preventive investments that are the highest priorities for state and local governments. Thus, the interventions being tested in most of the initial SIB projects are riskier, more innovative, and offer more potential learning benefits than we had anticipated.

While the accumulation of additional knowledge about what works is clearly a benefit of these more innovative interventions, their greater risk does raise questions, particularly for investors. So far, philanthropic capital has been the major source of financing for these projects and has been used as a backstop for private capital. It is unclear how quickly private capital might be able to take over for philanthropic capital in absorbing failure risk in future SIBs. A recent report found that many investors are uncomfortable with the prospect of being locked into a SIB contract with a long duration and concluded that future SIBs may need to involve more risk sharing from government.²¹

It Is Difficult to Find Interventions That Truly Pay for Themselves

Initial discussions have focused on initiatives that could yield budgetary savings that fully cover program costs, but most socially beneficial interventions are unable to meet this standard. It is an open question how often governments will be interested in signing on to projects that, for example, produce budget savings equal to 70 percent of their costs along with significant nonmonetizable social benefits (e.g., reduced crime, higher earnings, better health).

Finding Large Enough Sample Sizes Can Sometimes Be Difficult

To determine whether an outcome was produced by the intervention rather than by chance, a sufficiently large number of people must be served—generally at least 200 per year. This rules out some preventive investments that are targeted at high-cost populations that are very small.

Adequate sample sizes are also often critical to program economics. For example, in a small recidivism project, only “marginal cost” savings from reducing the number of prisoners will be attainable—those associated with items purchased on a per-prisoner basis, such as clothing, food, and, in some cases, medical care. Larger-scale projects have the potential to achieve far greater “average cost” savings, from reducing staffing or closing a correctional facility. In addition, the overhead costs of the SIB financing mechanism, including fees for legal counsel, intermediary costs, evaluation expenses, and costs associated with investor due diligence, are primarily fixed costs and will constitute a smaller proportion of the total project as the size of the intervention grows. In most cases, these costs are only worth incurring for a SIB contract worth at least \$20 million.

21 Steven Godeke and Lyel Resner, “Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape,” Godeke Consulting and The Rockefeller Foundation, November 2012, available at www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social.

Building Government Capacity Requires Dedicated Staffing and Expertise

SIBs are complex, novel arrangements and require a great deal of work to get off the ground. Governments face two main challenges in using this model. The first is sustaining focus over the year or more it can take to get a project up and running. Given all of the competing responsibilities of government officials, it can be hard to keep a SIB initiative on track without dedicated staffing. The second is technical expertise. Establishing a SIB requires expertise in areas such as incentive contracting, cost-benefit analysis, and evaluation design that may or may not already exist in house.

The Harvard Kennedy School's SIB Lab's assistance model attempts to address these challenges. We place a full-time "government innovation fellow" in the state or local government agency that is spearheading the state's PFS initiative. The fellow helps the agency both in coordinating its policy process and in performing technical analysis. The fellow reports to the state PFS policy lead and also receives supervision from SIB Lab Director Jeffrey Liebman, who provides direct technical assistance to the state as well. The SIB Lab also helps the state match and analyze administrative data sets to establish historical baselines, determine potential cost savings, and identify populations to serve. To date, this assistance model has been tested in Massachusetts and New York State.

Governments Are Taking Several Different Approaches to Identifying an Intervention

As already discussed, one of the key challenges in establishing a SIB is finding an intervention with a sufficiently high probability of success. We have observed governments using three complementary approaches to identify promising projects.

One approach relies on a policy process within government agencies. Officials often possess a wealth of knowledge about gaps in service provision and areas that offer the potential for budgetary savings if investments in prevention are made. It generally takes two or three meetings spaced over a couple of weeks to develop a good list of ten to twenty candidate projects using this method. At the first meeting, the SIB concept is explained, and questions about it are answered. At subsequent meetings, individuals brainstorm about ideas and then narrow down the list to the most promising options.

Under another approach, the government solicits suggestions from the public through a request for information (RFI). Both Massachusetts and New York State issued RFIs in an effort to collect suggestions for PFS projects from the public. The RFI process offers the potential to learn about promising projects and programs that government officials may not be aware of, as well as an opportunity to begin to engage with organizations that may ultimately become provider and intermediary partners. An open process for gathering ideas about projects also provides greater transparency, which can be important for experimental projects such as these.

The third approach, also widely used by governments, is to review evidence from sources such as the Coalition for Evidence-Based Policy’s “Social Programs That Work” list, the Washington State Institute for Public Policy’s cost-effectiveness studies, and recent research results from professional evaluation firms to find proven programs in priority policy areas that could be replicated locally. The benefit of selecting an option from one of these lists is that they provide evidence collected from rigorous evaluations, thereby providing far greater levels of confidence in the intervention’s efficacy. But the policy areas where proven interventions exist do not always overlap with a chief executive’s top policy priorities or with local provider capacity.

Through these processes, several types of interventions appear to be getting the most attention across multiple jurisdictions:

- Projects that aim to reduce recidivism among those released from prison or jail.
- Services for at-risk youth such as those aging out of the foster care and juvenile justice systems.
- Homelessness prevention services.
- Prenatal, early childhood, and preschool services.
- Preventive health care interventions such as those for asthma or diabetes.
- Home-based services designed to keep elders out of nursing homes.
- Employment/workforce development services.

Provider Capacity Is a Significant Challenge

In the states initially establishing SIBs, at most a handful of high-performing organizations in each policy area are capable of delivering services, and they tend to operate in limited geographic regions of the state. The current initiatives involve relatively modest expansions of provider operations. Finding a way to scale a successful SIB statewide or to transplant a successful one into a new state will be much harder and will present execution risk above and beyond the risk present in the initial projects.

Governments Have Several Options for Selecting Intermediaries and Service Providers

Some governments have undergone competitive procurement processes to select counterparties for the contract, while others have worked closely with a particular intermediary or a consultant from the beginning, relying on the intermediary’s or consultant’s expertise to identify a service provider and choose a program model. The competitive procurement process offers benefits from a transparency and legitimacy perspective and may allow the state to identify high-quality providers that it would otherwise not have been aware of. While competitive procurements are often slower than noncompetitive processes, establishing a SIB requires months of data analysis and other preparation within the government, as well as a process to

obtain legislative authority, work that can occur at the same time as the procurement process. Thus, the amount of delay caused by procurement processes is minimal.

New Structures Are Necessary to Enable Government to Commit to Future Payments

Investors have expressed concern about whether governments can commit to making future, success-based payments. In particular, given the annual appropriations process, questions have been raised about whether future legislatures might renege on commitments made today. The authorizing language enacted in Massachusetts addresses this issue, giving full faith and credit authority to success payments and setting up a sinking fund to steadily fund the payments over the life of the contract, rather than requiring a future legislature to appropriate payments on the back end.

Questions for the Future

Over the past year we have learned a great deal about the hurdles that must be overcome to get a SIB project off the ground. However, several questions remain unanswered about the future, not just of the projects currently under development, but also of PFS contracts more widely.

How Will This Model Become Sustainable and Scalable?

So far, it is not obvious that it will be substantially easier to create subsequent PFS projects after completing the first several. Those involved still need to establish relationships within government, build trust in the provider community, and create project-specific data systems and evaluation frameworks. In addition, it is unclear where sustainable funding streams for intermediaries and government capacity-building will come from. Because projects are relatively small and do not appear to yield supernormal returns, continued philanthropic support of both intermediaries and government capacity may be needed for quite some time.

What Aspects of the Pay for Success Structure Will Drive Better Outcomes?

PFS contracts introduce several potentially valuable components: performance measurement, performance-based pay, an intermediary with management talent, financial resources for successful nonprofits to expand, and new program models. A subset of these components may be sufficient for, or may explain a large portion of, an intervention's successful outcome. If the model is successful, we may not be able to tell the relative contributions of each. From the government operations perspective, a key benefit of the PFS approach is that it forces a sustained, multiyear focus on achieving improved performance in a particular policy domain. This type of focus can be very difficult to achieve with conventional public-sector funding and management approaches. In particular, leaders often create interagency task forces to tackle policy objectives, but then allow the enthusiasm and commitment to disappear shortly after the initial announcement of the task force.

How Can We Manage the Tension Between Targeting Innovative and Evidence-Based Programs for Social Impact Bonds?

For many social problems, we lack proven, scalable solutions, so what we need is innovation. But innovation is inherently risky, and investors in a SIB project, even those who are socially minded, may not be willing to take on that risk. On the other hand, with proven interventions, governments may simply want to fund the preventive services directly, without introducing the complexity and extra costs of a SIB structure. The challenge is to find the sweet spot of projects that are sufficiently innovative that they are hard to fund through the conventional budgeting process, but likely enough to succeed that investors are willing to back the projects.

How Should Risk Be Spread Among Project Partners?

In the initial SIB projects, philanthropic investors have assumed most of the risk of the projects. Little or no government payment has been required unless the projects meet their performance targets. This “money-back guarantee” structure has been very attractive to governments considering the SIB approach and is a big part of the reason that the model has spread so rapidly. But in the longer run, it may be necessary for governments to share more of the failure risk if SIBs are to reach their full potential. The pool of capital available and the number of policy areas where it will be possible to convince investors to take on all of the risk are likely to be limited. As the model evolves, it will also be interesting to see how large a portion of intermediary and provider fees will be linked to performance.

Will SIBs Be Used for Interventions Whose Benefits Accrue over Long Time Horizons?

Consider investments in prenatal health care. Such investments may produce short-term benefits such as improved infant and maternal health and lower health care costs, but they may also produce longer-term benefits such as reduced special education spending, reduced crime during teenage years, and increased adult earnings. While it would not make sense for a SIB contract to pay out over two decades as results become apparent—the feedback loop between management practices and results would be too long to be useful—it might be possible to design a SIB that paid out based upon short-term results that are predictive of longer-term benefits. It will be interesting to see whether any governments are willing to make payments based on these potential longer-term benefits.

How Will Governments Manage Pay for Success Contracts Across Political Administrations?

New administrations often replace and/or rebrand initiatives associated with prior administrations. It will be important to ensure that PFS initiatives have sufficiently broad support to persist. Building legislative support may be instrumental in making sure these initiatives become permanent features of the policy environment.

Can the Pay for Success Contract Align Incentives Across Different Levels of Government?

So far, we have seen initiatives that involve collaboration between agencies within one

level of government. We have yet to see state-local or federal-state partnerships, though the US Department of Labor grant proposal is a first step toward federal-state collaboration. In theory, the PFS mechanism should help build alignment between levels of government as it has between agencies within a single level of government. Until more collaboration starts occurring between levels, it may be particularly difficult for cities to use PFS contracting because the cost savings produced by a local initiative are likely to accrue in large part to county or state budgets.

How Will Governments Scale Pay for Success Contracts That Work?

In designing initial PFS contracts, it is important to have a vision for what will happen at the end of the contract if the project is successful. Clearly, it would be a bad idea to have the contract conclude, have services shut down, and then start the process of figuring out what comes next. But it is also not remotely possible to specify a plan for scaling up a successful intervention several years ahead of time since what is learned along the way will be critical to designing any follow-on plan. In practice, a sensible approach may be to write explicit decision dates about contract extensions and scaling into the original contract with sufficient lead time to allow for effective expansion. For example, if the initial contract is for six years, then by the end of the fourth year a decision would be made about years seven and eight. Another question is whether follow-on contracts should assume the same PFS model or whether the government could simply contract directly for the now-proven program model. Ideally, the government will maintain capacity to measure impacts rigorously during successor contracts regardless of their setup.

Conclusion

After two years of working on PFS contracts, we remain optimistic about their potential to overcome barriers to social innovation and speed up progress in addressing social ills. But there is still much to be learned about how best to structure these contracts and whether they can indeed produce better results for government social spending.

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