Injecting incentives into the solution of social problems: Social Policy Bonds

Ronnie Horesh

There seems little chance of achieving many social objectives, given that the ways in which they are being pursued fail to harness self-interest. A way forward is to create a new financial instrument – Social Policy Bonds – which would be auctioned by government. The bonds would be tradable and would be redeemed only when a specified social objective had been achieved.

Ronnie Horesh is an economist in the New Zealand Ministry of Agriculture and Forestry.

Introduction

Deregulation of Western economies and the freer operation of self-interest in the private sector have made many individuals wealthy. But the less well off have gained little, and many social objectives remain as remote as ever.

Many of these problems persist because they are tackled in ways that do not stimulate or reward self-interest. This is largely because their solution is in the hands of local or central government bodies, whose programmes suffer from a fatal flaw that almost guarantees they will be ineffectual and expensive: they reward people for undertaking activities, rather than for delivering desired outcomes.

Social Policy Bonds

My proposal is that a new financial instrument be created that rewards people only when they achieve targeted social goals. Social Policy Bonds (SPBs) would be issued by local or national government and auctioned to the highest bidders. Government would undertake to redeem these bonds for a fixed sum *only when a specified social objective has been achieved*. The bonds would be freely tradable after issue, and their market value would rise and fall. With an uncertain redemption date, and because they would not bear interest, SPBs would be quite different from conventional government bonds.

What social problems can SPBs solve? In principle, any that can be reliably defined and quantified. Key criteria for policy areas within which SPBs would show the most marked improvement over current programmes are:

- existing policies have objectives that are unstated, uncosted, obscure or conflicting; and
- financial rewards to those involved in achieving objectives are uncorrelated to their effectiveness in doing so.

Unfortunately there are many such policy areas, including crime prevention, employment, health, education, and air, water or noise pollution.

How would the bonds work? They would create a group of people (bondholders) who have a strong interest in achieving the targeted social objective efficiently, or in paying others to do so. Consider an example. Assume that an urban authority is prepared to spend a maximum of, say, £10 million to reduce the crime rate within its borders by 50%. It issues 1 million bonds that become worth £10 when the crime rate falls below 50% of current levels for a sustained period – say one year. Because the market is likely to see this objective as unlikely to be achieved in the near future, it may value the bonds when they are floated at as little as £1.00. (This sum would be used by the authority partially to offset the cost of future redemption of the bonds.) Now, the purchasers of the bonds hold an asset that could appreciate in value by 900% if a sustained halving of the crime rate is achieved.

Who would buy the bonds?

Many people would purchase these bonds with the idea of holding on to them until they could sell them at a profit. These *passive investors* would have no intention of doing anything to reduce crime. They would want to become 'free-riders,' hoping to benefit from any increase in the bond price without actually participating in any crime-reducing projects. But the way markets work would limit the opportunities for these passive investors. The more bonds they collectively own, the more remote the targeted objective becomes, the lower the market price of their bonds will fall, and the more they stand to lose as the aggregate value of their bondholdings falls. At some point, then, it would become worthwhile for passive investors either to become, or to sell their bonds to, *active investors.* These people, or institutions, would use their own capital, or borrow on the strength of the redemption value of their bonds, to initiate or facilitate crime-reduction programmes. Active bondholders would have an incentive to co-operate with each other to help reduce crime, and to do so as cost-effectively as possible.

Rewarding success

Consider some of the measures that bondholders could put into operation:

- encouraging neighbourhood watch schemes;
- encouraging parents to monitor their children's activity more closely;
- subsidising recruitment of unemployed workers;
- complementing police patrols with private security patrols; or
- subsidising widespread use of window locks or burglar alarms.

Many of these activities are, to some extent, undertaken by local bodies or some arm of government nowadays. The crucial difference is that, under a Social Policy Bond regime, people have incentives to seek out and develop those ways of reducing crime that are most cost effective.

Injecting incentives into the solution of social problems: Social Policy Bonds

A police force, a bureaucracy, or an environmental health department, however well-intentioned, is not rewarded in ways that correlate with its success in achieving its objectives – even if these are explicit. But under an SPB regime, the self-interest of bondholders acts so as to encourage those ways of reducing crime that give rate-payers the best return for their outlay. These ways may have been tried before, or tried in different cities, or they may be new and untried. Bondholders would be motivated to seek out, invent and use the most efficient methods for the city whose crime rate is targeted.

Of course, the bondholders need not participate directly in any crime reduction projects. Their role could be one of financing such projects, on the strength of the redemption value of their bonds, or on the strength of any increase in the value of their bonds. Their motivation arises from the anticipated supernormal profit arising from early redemption of the bonds.

Trading the bonds

Social Policy Bonds, once issued and sold, must be readily tradable at any time until redemption. This is critical to the operation of the SPB mechanism. Many bond purchasers will want, or need, to sell their bonds before redemption – which may be a long time in the future. With a secondary market, these holders will be able to realise any capital appreciation experienced by the bonds. This would give them a greater incentive to purchase the bonds in the first place.

But there is another important reason for requiring a healthy secondary market in the bonds: active investors may be able to speed up only one, or a few, of the processes necessary for the targeted objective to be achieved. Once these investors have contributed what they can, and seen the capital value of their bonds rise in line with the increased probability of the bonds' early redemption, they may have no wish to speculate on the speed at which the remaining processes will be carried out. Other groups of active investors, who will have greater expertise in performing these later processes, must be given an incentive to use their expertise to accelerate attainment of the targeted objective. The possible capital appreciation of bonds bought from previous owners and sold at a still higher price (or redeemed) provides this incentive. The new owners will, if they are successful in these later stages, realise this capital appreciation.

Cascading incentives

Bonds therefore could flow towards those who are most able to help solve the targeted social problem. In fact, though, it is not necessary for there to be any actual flow of bonds. Large bondholders might simply decide to subcontract out the required work to many different agents, while they themselves hold the bonds from issue to redemption. The important point is that the bond mechanism ensures that the people who allocate the finance have an incentive to allocate their finance efficiently and to reward successful outcomes, rather than merely to pay people for undertaking an activity. At the limit we can conceive of just one single buyer of all the bonds. If this buyer were determined to hold on to the bonds until redemption, then the bonds would function as a sort of performance-related contract, with the government paying only when the objective has been achieved. The buyer could contract out most, or all, of the work required to achieve the objective, with the incentives given by the bonds for speedy accomplishment cascading down from the bondholder to those subcontracted to do the work. Regardless of who owns the bonds, the SPB mechanism ensures the people who are charged with solving social problems are rewarded for success.

Too large a number of small bondholders would probably do little to help solve certain targeted social problems by themselves. It is likely then that the value of their bonds would fall until there were aggregation of holdings by people or institutions large enough to initiate effective problem-solving projects. Even these bodies might not be big enough, on their own, to achieve much without the co-operation of other bondholders. So there would be a powerful incentive for bondholders to *co-operate with each other* to help solve the targeted problem. Aggregation of holdings, and co-operation of bondholders, would stimulate effective problem-solving initiatives.

Definition and operation

For the Social Policy Bond regime to be effective, the targeted objective must be carefully defined, so that its achievement correlates strongly with what society wants to achieve. For instance, numbers of reported crimes could be targeted, if the objective is to achieve a safer urban environment. But this indicator may be unsatisfactory if, for instance, the crime rate becomes so high that people do not bother to report minor assaults or burglaries to the police. A more appropriate indicator might be derived from responses to victim surveys. Remember also that the objective will be a *sustained* lower level of crime.

Once an objective is close to achievement, the issuing body can float a new set of SPBs aimed at maintaining the achieved outcome, or at further improvements. The benefit per unit outlay of a second bond issue is likely to be higher than that of the first issue because, during the lifetime of the first issue, people would probably have developed more efficient methods and systems for solving the targeted social problem.

Advantages of a Social Policy Bond regime

The main advantage of Social Policy Bonds is that, by injecting self-interest into all stages necessary for solving social problems, they would be *more cost-effective* than current, activity-based programmes. For the same government expenditure, therefore, more can be achieved.

SPBs also make policy objectives more *transparent*. By focusing on outcomes, rather than activities, social objectives are explicitly identified, while indirect, as well as direct, means of achieving them are encouraged – but only if bondholders think them more efficient. Focusing on identifiable outcomes would encourage constructive participation in the political process, and mean that measures taken to achieve them would be more likely to attract public support.

The bonds also guarantee *stability* of policy objectives. SPBs could target goals with a necessarily long lead time and bondholders would not be deterred from taking measures to achieve them by fears of a reversal of government policy – or, indeed, a change of government. Moreover, for the bonds to be as successful as possible, governments would have to give assurances as to their future behaviour.

Because SPBs focus on outcomes, which can be broad, they have *informational advantages* that make it easier to consider tackling problems that would otherwise be addressed only on an *ad hoc* basis. Priorities for health service funding, for example, are strongly influenced by groups of medical specialists with little incentive or capacity to see improvements in the *general* health of the nation as an objective. So funding of these specialities depends on the strength of their lobby groups. And what is arguably the most efficient way of spending the taxpayer's health pound – preventive medicine – receives derisory funding because it has no powerful lobbyists.

Targeting broad indicators of well-being – life expectancy, infant mortality, disability – would ensure that scarce resources are allocated in ways that would directly achieve *society's* health objectives. It would be up to bondholders to explore the scientific and financial relationships so as to divert, impartially, their funding into those existing or new areas of the health service that would most efficiently use them to achieve the targeted broad outcomes.

More generally, most social problems will require more than a single project or programme for their solution. SPBs will encourage and reward the most efficient range of approaches. This occurs because of the nature of the bond mechanism, and requires no selection or supervision by government of the most efficient programme. Only the objective, not the way of achieving it, is dictated by government.

Government and markets

Government spending in Britain today amounts to about 42% of gross domestic product. Much of the debate about this spending centres around its size, rather than its inefficiency. Yet the two are linked: it is hard to voice the case for reducing the size of government when many social problems persist. And these problems persist because the government programmes that aim to tackle them reward doing, rather than achieving. People are paid for their time, rather than their efficiency or success. As a result, government programmes are cumbersome and inefficient. Typically they are unresponsive to events and lack ability to adapt to local circumstances. There is no incentive for the people who run them to do so efficiently. Even worse, some programmes have perverse incentives: if a police force, for example, is too successful at cutting crime one year, it may find its budget cut the following year. Or at least, the possibility that that might happen could have some effect on performance.

Social Policy Bonds, on the other hand, would be explicitly focused on outcomes. As such, they would command wider political support than activity-based programmes. And because they inject incentives into all stages necessary for solving social problems, they will be more efficient than current efforts.

Resources will always be limited and Social Policy Bonds will not change that. Priorities and choices will always have to be made: under the SPB principle, governments will still decide on which problems to solve, and on the sums allocated to their solution. But democratic governments are good at representing and articulating their people's wishes. Where they are not so successful is in working out the most efficient ways of achieving these goals. This achievement is really a

iea
ECONOMIC AFFAIRS
September 2000

matter of allocating scarce resources. In economic theory, and on all the evidence, markets are the best way of allocating scarce resources to achieve prescribed ends. Social Policy Bonds would allow both governments and markets to do what each is best at doing – respectively: prescribing ends, and allocating resources to meet these ends.

In the long run widespread acceptance that self-interest can be channelled into solving social problems could have more far-reaching implications. International, or even global, social or environmental problems, such as malnutrition or climate change, could be made the targets of future bond issues. However, the acceptance of a Social Policy Bond regime, even with the aim of achieving national goals as uncontroversial as lower unemployment, or better health outcomes, may be politically difficult, and must be a gradual process. But the potential benefits should not be ignored. By harnessing market forces in the service of social goals, SPBs could deliver better social outcomes with a much smaller public sector.