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ABSTRACT

The privatization of schools and school services is strenuously opposed by trade unions representing school district employees. This paper examines the opposing arguments advanced by the National Education Association and finds that the objections involve two distinct points: (1) the economic role of profit; and (2) idealism in the schools. The paper discusses each of the points, which are central issues in the debate between capitalism and socialism. The first point is based on the notion that profits are superfluous payments made to well-positioned, but undeserving, individuals; profits play no constructive economic role in an enterprise like a public school. The paper asserts, however, that two less visible costs are involved--capital and risk. The second point is based on the idea that profit-seeking is an unsound and potentially corrupting motive for the delivery of a public service, which should be based on altruistic, service-oriented motives. A conclusion is that the involvement of profit in the privatization of public schools should not be considered an objection. Profits, it is argued, are a way of recognizing costs that exist in all school settings, and the seeking of profits is no more selfish than the seeking of higher salaries, promotions, or job security. (LMI)

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Incentive Issues in Contracting Out**  
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EPI POLICY PAPER #1

## Profiting From Education: Incentive Issues in Contracting Out by James L. Payne

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In an effort to overcome high costs and low performance in public schools, many school boards are looking at the possibility of engaging private companies to manage tax-funded schools, or to provide other services to them. This idea is strenuously opposed by trade unions representing school district employees whose terms of employment might be adversely affected by such a change. For example, in its 1994 convention, The National Education Association (NEA) formally pledged to "oppose attempts by private corporations and individuals . . . to establish schools for profit in the public sector." Similarly, the smaller American Federation of Teachers (AFT) and several other AFL-CIO and independent unions strenuously oppose contracting with private companies to provide services needed by school districts.

An NEA document, "Corporate School Takeovers," illustrates the union case against contracting out. Among the issues the NEA raises is an objection to profit-making. It is wrong, NEA officials say, to involve the profit motive in the provision of a public service like education. Examination of the NEA arguments reveals that the objection involves two distinct points:

1. Profits are superfluous payments made to well-positioned, but undeserving, individuals; profits play no constructive economic role in an enterprise like a public school.

2. Profit-seeking is an unsound and potentially corrupting motive for the delivery of a public service, which should be based on altruistic, service-oriented motives.

It is worth taking a close look at these points, because they resurface time and again on a wide range of public/private controversies. They are, in fact, central issues in the debate between capitalism and socialism.

### I. The Economic Role of Profit

From time immemorial, the proverbial man in the street has had a hostile attitude toward profits. Farmers complain about middlemen who resell their product at a much higher price and pocket the profit. Workers complain about factory owners who sit back and reap a profit for "doing nothing." Marxism enshrines this skepticism in a comprehensive theory of economic life. Those who own the means of production, it runs, "exploit" workers by extracting a "surplus value," siphoning off wealth from the community. The socialist solution to this seeming injustice is to abolish private property and have the state own and run everything.

Teacher union officials appear to have accepted this anti-profit perspective in condemning the profits of private companies providing services to school districts. In "Corporate School Takeovers" the NEA expresses indignation over the profits, real or alleged, of such companies. Savings from efficiencies in the operation of schools, complains the NEA, "are pocketed as profit by the corporations that run them, not returned to taxpayers or reinvested in communities."

The hostility toward profits down through the ages can be traced to a simple circumstance: Profits are *payments made for economic contributions not immediately visible*. Therefore, to superficial or hasty observers--which is most of humanity most of the time--they

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EA 027246

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will seem to be unnecessary or illegitimate payments.

The hasty observer can understand that labor needs to be remunerated, and he can therefore recognize that the payment of wages is necessary. And he can also see that physical objects and materials--buildings, locomotives, coal--need to be paid for. At first glance, that seems to be all you need to run a railroad: workers, buildings, locomotives, and coal.

A close examination reveals, however, that there are two other less visible, but nevertheless essential, costs.

1. Capital: All organizations require some initial resources before they can generate any kind of product. Therefore, someone has to forego present consumption, to sacrifice time, energy, and money to get the operation going. In voluntary arrangements, where no one is being forced to support activities against his will, this sacrifice is elicited by promising to reward investors in the future. When the future rolls around and the railroad is functioning, it is easy to overlook that promise, but the fact is that the existence of the firm depended upon it.

2. Risk: All human enterprises face the possibility of failure. Therefore, the question arises: who will suffer the costs associated with a failure, if it should occur? In a voluntary economic arrangement, it is the investors. They can lose some or all of the money they put into the operation. To get investors to bear this risk, they are promised unusually large payments if the operation does succeed.

We thus see that "profit" involves two kinds of promises: a promise to repay something extra for foregoing present consumption, and a promise to repay something extra for risking the loss of capital. Both of these payments are combined in the profit figures one sees for the different securities in the financial world. In some

operations, where it is virtually certain that investors will get their money back, profits are almost entirely compensating investors for foregoing present consumption. They are rewarded with something like a yearly payment equal to eight per cent of the money invested. As the risk of losing principal increases, the potential reward must rise to attract investors, so that an annual return of 20 or 30 per cent, or more, is expected.

It would be difficult to imagine an enterprise more fraught with risk than that of trying to bring efficient, innovative management to the public schools. One danger comes from regulation. Schools are subject to many levels of local, state, and federal regulation, not only as concerns education, but everything else: health, safety, environment, drug enforcement, employment, affirmative action, disabilities, and so on, not to mention the perennial threat of liability suits for anything--or nothing--at all. All these government-created threats are a field of mines: at any moment, one can explode imposing prohibitive costs on a private firm and driving it into bankruptcy.

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Another problem is the opposition of unions to efficient, innovative management. Unions demand burdensome work rules, job protections, and excessive pay and fringe benefits. They can block the flexible management a school would need to make savings. And through their opposition to educational research and development, unions stand in the way of increased productivity. And, of course, when unions do strike, they cause a total loss of production which, for any private company, can be very damaging or even ruinous.

All these different problems and dangers mean that providing educational services to tax-funded schools is especially risky. Investors can--and do--lose money in making the attempt. Therefore, they need to be promised a high return if and when the firm succeeds in delivering a valued service.

A profit may be a legitimate payment in a private investment situation, critics will say, but why should school districts pay it? At first glance, it appears that government activities, not being based on the voluntary processes of the marketplace, are able to gain efficiency by not having to pay for capital or risk. They can extract money through the coercion of taxation, so there is no need to entice investors by offering fair terms for the use of capital.

Although a tax authority is not required to compensate contributors for making sacrifices and assuming risks, this does not mean that these costs go away. School organizations face capital costs just like any other operation. Suppose, for example, that a new school building is to be built. Someone will have to sacrifice present consumption to build it. It may be the taxpayers, in the form of a greatly increased tax bill, or it may be investors, through the use of a bond issue. The investors are paid interest (their profit) for advancing the school district the money.

Schools also face all the costs associated with risk. What happens in a school district run by government officials is that administrators themselves never bear any of the risks: they shift all these costs onto taxpayers, parents, and students. Suppose, for example, that regulators require the removal of asbestos from school buildings. The job—which turns out to have been unnecessary—costs \$1 million and means that schools start two weeks late. This is the typical kind of regulatory "bolt from the blue" that, in a private firm, would cost investors dearly. In the public school system, the burden of this unanticipated cost will be shifted onto taxpayers who will be forced to pay extra, onto students who lose two weeks of education, and onto parents who have to provide day care for children during that time. The school superintendent (whose ineptitude may have played a role in the fiasco) is paid as much as ever.

The biggest risk of all, the risk of failing to deliver a good educational service, is always present in all schools. And it has materialized in

many thousands of school districts where students are underperforming. Those who have supplied the faulty education suffer no loss. That is one of the main arguments for bringing private firms onto the educational scene: unlike government officials and employees, the private firms will bear the costs of their failures. When

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unionized teachers and government administrators fail to deliver a satisfactory educational service, teachers' pay isn't slashed and administrators aren't fired. In the standard government school model, all risks of failure are shifted onto parents, taxpayers, and children. Parents and taxpayers are increasingly finding this doctrine untenable.

## II. Idealism in the Schools

People are skeptical of purely monetary motivation. We mistrust people who do a job "just for the money." Is this concern justified?

If systems of controlling workers were perfect, it would not be. If an employer, for example, could know about, and reward or punish, every minute action of the employee, then it would not matter if employees were totally self-centered and uncommitted. Employers could rely on the system of comprehensive control to regulate their behavior.

In real world organizations, however, monitoring systems are highly imperfect. Those who wish to supervise workers—employers, consumers, taxpayers—are not able to know about and control most of what the workers do. We have to put a great deal of trust in people who are supposed to deliver some service or product. This is why we suspect monetary motivation. The home builder who builds a house for us "only for the money" worries us, because we know there are many aspects that we aren't going to be able to supervise. The builder can cut corners, do shoddy work, and misrepresent things, and we may never find out about the shortcomings. So naturally we want a contractor who is dedicated to building high-quality houses, one for whom doing the job right



is more important than money. In other words, we want an idealistic home builder.

In education, the problem of supervision and control is especially acute. Parents, taxpayers, and school boards have great difficulty learning about and controlling the behavior of teachers and administrators. Over the years, we have erected an enormous (and costly) apparatus of rules and regulations in an attempt to mandate desired behavior. But these rules are mechanical, blind, and generally incapable of motivating constructive behavior. There is no way around it: a good school requires dedicated, idealistic personnel, teachers and administrators who are not merely "in it for the money."

It is, therefore, at first glance disturbing to hear that a school may be turned over to profit-making entrepreneurs, because it appears that money will become the dominant motive. The NEA makes this point in "Corporate School Takeovers," arguing that firms will "cut corners to protect and enhance profits," and declaring that "The first and foremost obligation of for-profit managers of public education is not to the public and students but to their stockholders. The bottom line is profitability rather than efficiency and educational quality."

The point is well-taken. We are right to be skeptical about providers who place undue emphasis on financial rewards. However, it is incorrect to suppose that selfishness figures only, or even principally, in connection with profit-making companies. A self-centered orientation can dominate any human organization, including those that are supposed to be run on public service principles. In politics, for example, elected officials now demand high salaries and lavish pensions and fringe benefits--much to the disgust of voters. The world of giant non-profit organizations is similarly corrupted by greed, with six-digit salaries the almost universal practice. At United Way of America, the president, William Aramony, was extracting a salary of \$390,000, plus a million-dollar pension and other lavish benefits. When this business-as-usual selfishness was made public, Aramony was

forced to resign (and later jailed). The United Way is supposed to be a charity, but that doesn't mean its officials are idealistic.

Teacher unions are hardly in a position to accuse anyone of "greed." Legally and practically, their role is to serve the selfish needs of their members. They focus upon extracting material benefits, not promoting idealistic goals. Unions are in the business of demanding higher wages, job protection, shorter hours, and so on. By their willingness to strike and thus deliberately deprive their students of education, unionized teachers have demonstrated that they put their material self-interest above educational priorities. Supervisory personnel, for their part, have developed their own labor cartel to protect their jobs and maintain their high salaries.

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The NEA is quite right that "money-grubbing" is an unhealthy sign in education, but that is, sadly, the dominant tone in many school districts today. In Hartford, Connecticut, where less than one per cent of the students taking the 1995 Connecticut Academic Performance Test fulfilled grade level expectations, the average teacher salary is \$58,800 plus 28-33% more in fringe benefits. The emphasis on material rewards also means means that parents, taxpayers, and school boards must now be suspicious about the quality of education, and about the evaluation of that education. At Brea Olinda High School in Orange County, California, administrators falsified over 600 grade records to make student performance look better than it was. There was no profit-seeking here, but promotion-seeking and fame-seeking. The falsifications enabled the school to be designated a "Blue Ribbon School" by the U.S. Department of Education.

The spirit of deception that has led to cheating, grade inflation, and dumbing down the curriculum is also reflected in the self-serving way administrators and unions present facts and figures about salaries, fringe benefits, workloads, budgets, and projected costs. It is difficult to trust any figures coming out of the public schools these days.

Profit-making firms could hardly worsen this culture of self-interest. To the contrary, they could help the schools move away from it. It is a mistake to assume that there are no idealistic motives in a for-profit firm. Down through history, many idealists and visionaries have chosen to pursue their goals through commercial firms: Thomas Edison, Alexander Graham Bell, George Westinghouse, and so forth. Such men were engrossed by the challenges of bringing improvements to the world. From what we know about them, they were willing to make great personal sacrifices of time, money, and convenience to make their dreams come true.

A business firm is often the best vehicle for developing and promoting an innovative idea, for it allows the idealist both flexibility and control. Beatrix Potter, writer of the Peter Rabbit books, went into business for herself as publisher and distributor of her books. She did not do this mainly to extract wealth, but because she believed in her work and wanted the world to have it.

Naturally, commercial firms vary widely in the degree to which they reflect idealistic, as opposed to self-serving, motives. Some firms are

self-centered and untrustworthy, but many are idealistic and service-oriented.

In conclusion, while there may be a number of objections to privatization in the schools, the fact that "profits" are involved should not be considered one of them. Profits are simply a way of recognizing costs which exist in all school settings. In government-managed schools, the costs may not be as visible, and they may be shifted onto other participants, but they are still there.

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The seeking of profits is no more selfish than the seeking of higher salaries, promotions, or job security—which teacher unions and government administrators do all the time. In the current context, a profit-seeking educational firm might well have more idealists dedicated to quality education than the school bureaucracy it offers to replace.

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