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ABSTRACT

Although the theory of the market is well understood, little is known about how for-profit schools will operate in practice. This paper considers why for-profit schooling has developed during the current period and not before (e.g., entrepreneurs must compete against heavily subsidized public schools, which limits their ability to charge prices that fully cover their costs). It also discusses the main input differences between for-profit and public schooling, explaining that the main areas where public, for-profit, and nonprofit schools differ are in their personnel practices, professional development, and managerial practices rather than in their instructional practices. Finally, it examines how for-profit schools will have to attract students as clients. If states and districts insist on using state standards and tests to judge school performance, for-profit schools will not be able to differentiate themselves with claims of superior student achievement. It suggests that given current evidence, the scope for efficiency gains appears limited. Research has not identified substantial economies of scale in education, and for-profit schools may have to devote more resources to marketing their provision rather than to the provision of education. (SM)

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Thoughts on For-Profit Schools

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Abstract – Although the theory of the market is succinct and well understood, we know little about how for-profit schools will operate in practice. This short paper considers why for-profit schooling has developed during the current period and not before; what are the main input differences between for-profit and public schooling; and how for-profit schools will have to attract students as clients. Given current evidence, the scope for efficiency gains appears limited - research has not identified substantial economies of scale in education and for-profit schools may have to devote more resources to marketing their provision rather than to provision of education.

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The recent entry of for-profit schools into the K–12 arena is an intriguing trend. Their promise is that their endless quest for new customers will drive them to innovate at a faster pace than not-for-profit and public schools. The discipline of market economics supposedly will force for-profit schools to streamline their bureaucracies, retain and reward highly talented administrators and teachers, and raise student achievement on a variety of measures. They will be more responsive to consumers and more accountable to local authorities. In short, they claim to offer a better product at a similar if not lower price. In turn, their siphoning of students will cause not-for-profit and public schools to rethink their approaches to schooling. They will seek to learn from and replicate the more efficient management structures and more effective instructional methods of the for-profits. If all goes according to the free-market theorist's model, introducing the profit motive into education will spark a perpetual discovery process that benefits students, employees, and, let us not forget, investors.

So much for theory. The fact is that we know little about how for-profit schools will operate and how they will affect students and other schools. At least three major questions have yet to be answered satisfyingly:

- If schools are a potentially profitable endeavor, then why did entrepreneurs wait so long to enter the market? Is there something unique about schooling that makes it difficult to earn a profit?
- Now that we do have for-profit schools, how will they achieve cost savings? Will they bring fundamentally different approaches to education through curricular and technological innovations that will "break the mold"?
- Even if they are more effective or less costly, or both, will they earn profits that are comparable to the returns on other investments?

Why Now?

That for-profit schools have only now become players in the K–12 market is puzzling, given that public schools have been around for two centuries, independent schools for four. Among the 28,000 or so independent schools in the United States, probably no more than a few hundred have gone the for-profit route. Many of these specialize in education for the severely handicapped and charge very high fees, which are usually paid by states and school districts to meet the federal special education mandates. Only in the past decade have we seen the onset of major efforts to establish for-profit schools for a broad range of students in K–12 education. For the most part, education management organizations (EMOs) such as Edison Schools and Advantage Schools, the two best-known EMOs, have sought to manage charter schools or public schools under contract to school districts. (Note that for-profit firms have always had a significant role in K–12 education by providing various products and services to schools, such as supplies, textbooks, transportation, and food services.)

What stopped investors, entrepreneurs, and educators from taking advantage of the profitable opportunities in running schools over the past century? In essence, what took so long? Is it possible that few saw potential profits in schooling in the past? Then the question becomes "what has changed to create the opportunities that are perceived today?"

One reason that entrepreneurs may have been reluctant to enter the schooling market is that they must compete against heavily subsidized public schools, which limits their ability to charge prices that fully cover their costs. Thus, the market has been left to those nonprofit organizations that can raise adequate subsidies to keep tuition low. But that does not explain the existence of private schools that compete very effectively with public schools in virtually every metropolitan area and whose tuition levels far exceed public school spending. In my city, New York, elite private schools such as Dalton, Horace Mann, Spence, Brearley, Riverdale Country School, and at least two dozen more levy tuition in the range of $20,000 a year—exceeding what even the wealthiest New York suburban school districts spend per student. Yet they always have more applicants than openings, a surplus that is maintained in good and bad economic times. Isn't this the kind of niche market that profit-seekers salivate over? But here they are invisible.

The problem for entrepreneurs is that for-profit schools compete at a disadvantage against not only public schools but many nonprofit schools as well. For a variety of reasons, virtually all private schools set tuition below the level that would allow full cost recovery. For instance, I serve on the board of a religious private school that must raise half of its budget, despite a price tag in the $13,000-a-year range for high school. One could argue that this subsidy is necessary to attract an adequate number of students. But this year, its seventh in operation, the school had more than twice as many applications as openings for its freshman class.

Fund-raising remains important for such schools, which often provide scholarships to some portion of their students who cannot afford full tuition. In some of the less-expensive independent schools, the fund-raising subsidies are needed to cover operating costs. Moreover, fund-raising often still isn't enough. Many of the nonprofit independent schools are also subsidized with below-market personnel costs, donated facilities, and other payments in kind, benefits that are rarely if ever showered on for-profits.

Further complicating the for-profits' task is the fact that the nonprofits with the highest tuitions also have the highest endowments and most vigorous fund-raising efforts. In conversations with their headmasters, one gets the impression that they see themselves, proudly, as sponsoring activities that are not economically justified by tuition charges. These include extensive community service programs for students and a much wider range of co-curricular and extracurricular activities and athletic teams than their school enrollments would justify. They also provide a range of educational amenities whose costs exceed the tuition allotted for them, from very small classes and seminars (10 or fewer students) to guided independent study.[1]

In short, even the most expensive private schools with the most elite clientele fail to cover their costs with tuition. This goes far in explaining why entrepreneurs have shied away from the K–12 market. This is not to say that an individual, for-profit, family-owned school can't survive. I know of a few for-profit schools at the K–12 level and more at the preschool level that appear to be marginally profitable. But much of what appears as profit is due to the family members' hard work for little pay. The salaries they draw on the school understate the value of their time, leaving the impression that the enterprise is profitable.

Whether this can be replicated on a large scale by corporate entities is doubtful. Historically, economic studies have not identified substantial economies of scale in education at school sites or in multi-school endeavors. Perhaps this is for the reason suggested by John Chubb and Terry Moe in Politics, Markets, and America's Schools (1990): that the best results are obtained when schools are given great autonomy.[2] A corporate competitor in schooling must establish brand and product identity, which necessitates relatively uniform operations and services from site-to-site. This puts the need for quality control and similarity from site to site in direct competition with the need to be responsive to differences among particular clients and settings. Moreover, as the economist Richard Rothstein has observed, as corporate entities expand to more and more schools, they are likely to have to rely on standard operating procedures and monitoring to maintain quality control and brand identification. Paradoxically, this is the argument given by states and school districts for their

[1] Compare this behavior with the analysis of the foremost authority on the economic behavior of the non-profit organization, Burton A. Weisbrod, "Modeling the Nonprofit Organization as a Multiproduct Firm: A Framework for Choice," in Burton A. Weisbrod, Ed., To Profit or Not to Profit (New York: Cambridge University Press, 1998), pp. 47–64.
[2] John E. Chubb and Terry M. Moe, Politics, Markets, and America's Schools (Washington, D.C.: The Brookings Institution, 1990).

"over-regulation" of public schools—namely, that equity among schools and students requires uniformity that must be secured by mandates, rules, guidelines, and regulations.

Under New Management

The mandate to cut costs and turn a profit inevitably will dictate some of the for-profits' personnel and instructional practices. Education is a highly labor-intensive activity, with wages usually accounting for 80 percent or more of the school budget. This means that the main cost-cutting opportunities lay in cutting personnel costs by using either cheaper personnel or fewer of them. Thus the for-profits may use more part-time personnel (forgoing staff benefits), less experienced teachers whose salaries are lower, larger class sizes, or shorter school days. Substituting capital for labor in the form of computers and educational technology may also be possible, although there is little evidence in the educational industry that this has been an effective cost-cutting strategy.

For now, though, the differences among the for-profit, nonprofit, and public education sectors seem mainly cosmetic. Their approaches to educating children change little from sector to sector. The for-profits generally have adopted curricula that are available commercially to all schools. Many public schools and nonprofit schools have long used similar curricula. Instructional practices also do not seem to differ very much. Some public, some nonprofit, and some for-profit schools use direct instruction while others use more "progressive" approaches. The three sectors overlap so much in their curricula and instructional practices that it is difficult to distinguish them from one another.

Some of the for-profits rely more heavily on sophisticated use of educational technologies. But so do a large number of public schools. Some also provide tutoring services and extended school days and years. But so do many public schools. Given these similarities, it appears that curriculum and instructional practices vary far more within each sector than they do among the three sectors.[3]

Where the three sectors do seem to diverge is in their personnel practices, professional development, and managerial practices. Given that the growth in for-profit schools has been mainly in contracting with public schools or charter schools to operate individual public schools as EMOs, how much they diverge often depends on state laws and school district contracts. Some states and districts require EMO-managed schools to hire certified teachers or even to retain the existing teacher force. They also may require them to enforce the existing collective bargaining agreements, leaving the tenure policy untouched. In other states, for-profit entities have much more leeway in whom they hire and in designing their employee contracts.

Where the laws have granted them flexibility, for-profit schools have tended to hire their teachers with less concern for whether they have met certification requirements. In some states they need not meet conventional certification requirements at all. The for-profit schools prefer to hire for a fixed term, renewing only the contracts of teachers who have been judged effective. They also rely on various versions of merit pay, usually rewarding some teachers for subject specialization and other talents in order to retain valued teachers and to provide incentives for improvement. In some cases, the incentives include more extensive career ladders for classroom teachers than the public schools offer.

Some for-profits, like Edison Schools, the largest EMO, emphasize strong professional development by providing as much as three weeks of training a year for teaching staff. By contrast, public schools typically provide only three to four days of staff

[3] For a theoretical explanation of why public and private schools are similar, see Byron W. Brown, "Why Governments Run Schools," Economics of Education Review 11(4), (1992), pp. 297-300.

development a year, with little follow-up or assessment of results. In my view, this is an important difference between the two sectors, since strong and cohesive professional development sessions with subsequent mentoring and assessment is one of the most promising methods for heightening school effectiveness.

For-profit schools also give their principals more decision-making powers and provide more incentives for making effective decisions, particularly with regard to personnel practices. They expect principals to monitor the selection and hiring process as well as teacher assessment and to retain only those teachers whom they consider highly productive. This flexibility does not, however, carry over to the academic realm. Corporate entities run many of the new for-profit schools, and to establish their brand identity they have sought relative uniformity in instructional practices from site to site. For example, Advantage Schools uses direct instruction in all of its schools, an approach that relies heavily on teacher lectures and drill. Because the use of direct instruction is one of Advantage's selling points, its school principals have no leeway to deviate from this approach. Other firms have selected specific curricula for each learning domain, and all of their schools are required to use these curricula in the same way.

Attracting Clients

The issue of brand identity raises questions about how for-profit schools will sell themselves in the education market. If their instructional practices don't vary much from those of their public and private competitors, how will they differentiate themselves?

We have too little experience with for-profit schools to answer this question fully. What is clear is that schools will avoid the notion that they are interchangeable, producing similar products and competing on price alone, as the model of perfect competition assumes. Without a voucher system in which parents may supplement the voucher, for-profit schools will be bound by fixed per-pupil allocations, hindering their ability to compete on price. Thus I would expect that they would seek to differentiate themselves from other schools with claims of superior student achievement (difficult to prove in the absence of sophisticated and costly evaluations by third parties) and by using marketing images to persuade parents and school boards that they offer a superior education. If a firm wishes to expand to many schools, then it must have a brand image and at least some evidence that it is succeeding systematically across school sites. The best way to accomplish this is to set unique goals that will apply to a client niche and claim effectiveness on those goals rather than to compete on similar dimensions with every other school. This is precisely the strategy followed by the middle and upper strata of the nonprofit schools. For example, most private high schools refused even to participate in U.S. News and World Report's attempt to rank the nation's best high schools. Likewise, in New York State, a large portion of private schools have sought waivers from the state's requirement that all schools participate in the Regents examinations—for which the state will publicly report the scores.

But, if states and school districts continue to insist on using state standards and tests to judge school performance, then the for-profits will be pushed to compete for contracts and clientele on the basis of a narrower set of criteria. This would give the for-profits, with their more flexible managerial and personnel policies, some advantage in the marketplace. They will be able to hire and maintain a teaching force with the goal of higher test scores in mind, and they will have more flexibility than public schools do to reward or punish their teachers on the basis of test results. For-profit firms are most effective when they focus on tight objectives rather than the normally diffuse activities that we demand from public schools.[4] These narrow goals will also give for-profit schools a powerful incentive to admit

[4] See Weisbrod, op. cit.

and encourage those students whom they expect to do well on achievement tests or who are likely to show the greatest value-added-that is, the greatest improvement in test scores. (There is some reason to believe that it is the lower-middle portion of the student distribution where test scores are most malleable over the short run, as opposed to those students in the least-advantaged or most-advantaged circumstances.) Such policies will pressure the for-profits as well as other schools to "teach to the test" and to provide considerable test practice. If profits are tied to test scores, then the pressure will only build.

There is one area in which costs will most certainly be higher than for public schools: that of marketing and promotion. For-profit schools, especially those with regional and national ambitions, must establish a brand identity for their schools and must also promote themselves intensively to penetrate their markets. Currently this marketing effort is devoted mainly to school districts and charter-school prospects in order to obtain contracts. At the district level, this means considerable lobbying of board members and administrators as well as parents. It also may mean informational retreats at pleasant venues for board members and superintendents and many meetings with stakeholders such as teachers and other unions and parents. Even under a system of vouchers, the emerging competition will require intense marketing to distinguish one EMO's schools from the crowd. All in all, marketing and promotion inevitably will absorb resources that could have gone to instruction.

My observations here are limited by our lack of experience with for-profit education. But there is much to be learned from the case of Chile, where a voucher system has been in place for two decades.[5] In Chile, students are found in four types of schools: elite schools that do not accept vouchers and charge considerably more than the voucher; for-profit

[5] Patrick J. McEwan and Martin Carnoy, "The Effectiveness and Efficiency of Private Schools in Chile's Voucher System," Educational Evaluation and Policy Analysis (forthcoming).

voucher schools; nonprofit (usually religious) voucher schools; and municipal voucher schools. Since the voucher was introduced, voucher schools have grown considerably—from only about 15 percent of enrollments in 1981 to about one-third of total enrollments in 1996—and for-profit schools accounted for the majority of the growth. For-profit voucher schools have lowered their costs by hiring part-time teachers (who are often teaching full-time in municipal schools), paying lower salaries, and enlarging class sizes. They devote considerable effort to differentiating themselves in the marketplace, often by choosing English names that connote a patina of prestige. Studies show that after adjusting for student characteristics, the for-profit schools achieve at a slightly lower level in Spanish and mathematics than both the municipal and Catholic schools. Since their costs are lower, however, they are also somewhat more cost-effective. There are no dramatic differences among the three voucher-funded sectors.

Will for-profit education evolve here as it has in Chile? The lack of extensive experience with for-profit schools in the United States means that almost any assertions are speculative. We are going through a period of great experimentation as more and more for-profit firms enter the market to manage schools for the public sector or establish their own schools. Unfortunately, none of the EMOs has been around long enough for us to draw any firm conclusions. And, given their current balance sheets (none has announced profits yet), many may not be around for the long haul.

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