

Correspondence With Milton Friedman Concerning Advantages Of For-Profit Schools Over Private Non-Profit Schools And Other Related Topics

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Letter and report (“K-P Education: Superior For-Profit Schools through Franchising.”) to Milton Friedman from David Anderson seeking his comments. Sent July 9, 2003.

Letter to David Anderson from Milton Friedman stating that we’re “singing the same tune.” Sent July 23, 2003.

The report itself, “K-P Education: Superior For-Profit Schools through Franchising.” This 13 page word document, dated July 9, 2003, is the one that was sent to Dr. Friedman.

5 Bank Street, #3I
Attleboro, MA 02703

July 9, 2003

Professor Milton Friedman
Hoover Institution on War, Revolution and Peace
Stanford University
Stanford, CA 94305-6010

Dear Dr. Friedman,

I was active as the Speakers Bureau coordinator in the Proposition 38 campaign. I'm the fellow who sat at the table during cocktails with you, your wife and Bob Poole when Tim Draper had his "kickoff" party. I believe I told you about some of my work for Bret Schundler in New Jersey.

Anyway, I have decided to do what I can to advance the school choice cause by trying an indirect approach. I want to do that by means of getting involved with for-profit schools and the franchising thereof.

I wrote a report that I've been circulating to generate some interest. I quote you in it and I apologize if I have not been faithful in reporting the essence of your remarks. I have enclosed the report, "K-P Education: Superior For-Profit Schools through Franchising."

I sometimes call this project Kentucky Fried Education, in part, because my brother encouraged me in this project by noting that Harlan (the Colonel) Sanders started his franchised KFC chain at age 63; I'm a mere 62. I presume that Madison Avenue types will not favor such a name.

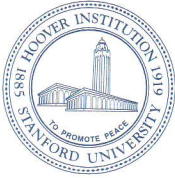
I should say that a remark you made during or after the PBS debate in 2000, regarding home schooled children's performance really was one of the seeds that led me down this present path. I thank you for that.

Any feedback on this would be most appreciated.

Sincerely yours,

David V. Anderson

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HOOPER INSTITUTION
ON WAR, REVOLUTION AND PEACE

July 23, 2003

Mr. David V. Anderson
5 Bank Street, #31
Attleboro, MA 02703

Dear Mr. Anderson:

Thank you for your letter and for your memorandum on franchising stellar schools. You and I are certainly singing the same tune. There is nothing in your memo to which I take objection. On the contrary, I agree with the whole of it.

If I have any difference it is in the degree of optimism about the possibility of succeeding. As you well know, Edison started out with essentially the same plan as you did. It was going to establish separate stand-alone private schools independent of government subsidy. It was driven by market reaction to go into the very different business of managing public schools. Yet, on the other side, I have long been puzzled by the situation in cities like New York and San Francisco: there are strictly private elementary and secondary schools which charge very high tuitions and have long waiting lists, and I keep asking why is it that other private enterprises haven't taken advantage of that situation as a source of profit. Somehow there is a customer base there; there is a market opportunity.

I have no advice to give about how to create the model stellar school that you can franchise. That is presumably what you are working full time on. I wish you every success with the project.

Sincerely yours,

Milton Friedman
Senior Research Fellow

P.S. One page appears to be missing from the copy of your memo that I got. It is the third page from the end.

F:v

Executive Summary

K-P Education: Superior For-Profit Schools through Franchising

by David V. Anderson

July 9, 2003

We are considering the establishment of a chain of franchised for-profit schools that will cover the K-12 curriculum in a shortened period of K-9. K-P refers to K through prep school.

Given that children circa 1900 covered the K-12 ground typically in about 8 years of elementary school, we believe that children will be able to perform well if given the appropriate schooling in sufficiently superior schools. We have chosen the term, “stellar schools,” to refer to the superior for-profit schools we envisage.

It is our view that, on average, contemporary non-profit private schools only perform marginally better than public schools because of their non-profit nature. It limits their opportunities to excel and grow.

Economists from Adam Smith to Milton Friedman have recommended a marketplace for education where the profit motive is allowed to sort out the winners and losers. Until recently, historical trends were moving the education industry into the socialistic format in which the government funded and ran the schools. With the decline of socialism, as an economic system, there is the opportunity to seek free market solutions.

We see two avenues along which such an educational marketplace can be developed: (1.) Providing parents and students the wherewithal (grants, vouchers, tax credits, scholarships) with which to pay tuition, and (2.) Creating superior for-profit private schools that will attract customers even in the absence of grants to parents. Our emphasis is on the latter, requiring no legislation and it does not directly affect public schools.

While competing against subsidized giants is difficult, there are examples of successes in other industries wherein sufficiently superior products have carved out profitable niches in the marketplace.

To support our contention that children can complete the K-12 curriculum in the ten years we call K-P, we have reviewed the performance of home schooled children who generally attain 12th grade skills when they complete the 8th grade. This seems to establish K-P as a reasonable period for their preparatory education.

Further encouragement for our project comes from the successes of EMO (Educational Management Operation) companies that are for-profit operators which run some public and public charter schools under contract. We also cite the robust and profitable for-profit post secondary education industry.

Finally, there are a few for-profit elementary and secondary schools that have demonstrated two essential ingredients of success: (1.) Significantly expanding markets (indicated by waiting lists to get in) and (2.) Healthy profits. The preliminary indications that the for-profit schools' 8th grade students tested at the 93rd percentile are consistent with the notion of truly “stellar” schools. This is apparent when one notes that public, non-profit private, and home schools have 8th grade test scores of approximately 47th, 72nd, and 81st percentiles, respectively. An important caveat is that these results may include various statistical biases.

We believe that the known facts about the different types of K-12 schools financial and academic performances suggest that the industry is ripe for the introduction of more for-profit schools. It would seem that the franchise model will be a good way to exploit these opportunities.

KP Education: Superior For-Profit Schools through Franchising

By

David V. Anderson

July 3, 2003

Goal

Our goal is profit. Financial profit and societal profit. We believe that schools can be established that are significantly superior to what currently passes for K-12 public or private education. We intend to provide the K-12 curriculum in the ten years K-9. We call this KP Education: kindergarten through prep school. Thus children will typically complete their college preparation at age 14 giving them a leg up on their cohorts “lost” in the contemporary systems of education. To maximize the efficiency of the new “system” we propose to build, test and then franchise schools of this type.

Among the parties likely to profit from this new “paradigm” in education are:

- The franchiser
- The franchisee- the local school owner and operator
- The student
- The parents

To drive home the franchise aspect we also thought of using the acronym KFE to “officially” stand for K-Freshman Education or “unofficially” Kentucky Fried Education!

Strictly speaking our proposal is not a “public policy” proposal because we are not seeking any legislation or changes in regulations. As such our project will not directly affect public schools. There would likely be an indirect effect through the additional competition this approach would introduce into the educational marketplace. We believe competition will spur public and non-profit private schools to improve.

Background

Fulfilling the Promise of Public Education

The historical record, anecdotal accounts and statistical data all suggest that most Americans had a reasonably good educational system in their communities in the early part of the 20th century¹. In those times, the governance of schools was community based and parents could exercise considerable influence over the school policies. There was no bureaucratic tangle of administrators and teachers were seen as independent professionals. The idea of teachers’ unions was far off into the future. Private schools existed in abundance and in some states, such as Maine and Vermont, taxpayer support of education was largely provided through universally available government scholarships to private schools.

Much has changed over the intervening century and in many ways our systems of public and private education have not improved. In recent decades rapidly expanding per pupil expenditures have not produced significant improvements in student performance. There is, of course, much debate over the degree of the problem, over who should be held responsible, and over the remedies to apply. Since public schools are government institutions, changing them is necessarily a political process. It is not our purpose in this report

to engage that debate. Rather we want to explore what can be done privately by for-profit entrepreneurs to augment the choices parents have in choosing the schools their children attend.

That said, I must confess that in other “spheres” I am an advocate of expanded school choice so parents, regardless of income, can have the same choices of schools enjoyed by parents of ample means. And while I personally support such “devices” as vouchers, tax credits and private scholarship foundations as instruments of choice, they are not the topic of this discussion. To discuss them would require discussing public policy, legislation and the like- something that in my foregoing comments I promised I would avoid.

Faltering Public and Non-Profit Private Schools

Borrowing the title of a silly movie, “Dumb and Dumber,” I think these terms fit reasonably well what currently “passes” for K-12 education in the non-profit private schools and their public counterparts, respectively. This dismal picture- even as portrayed by the late Albert Shanker (former president of the American Federation of Teachers union)- was that 8th grade graduates circa 1900 were educated about as well as our current “crops” of 12th graders. A key point here is that the private schools, by and large, have also suffered this degradation, though perhaps to a lesser extent than the public schools.

This fits with the well-known but unspoken policy of the educational establishment to “dumb down” the curriculum standards. Since minimum curricular standards are generally imposed on both public and private schools, both have suffered to the extent that they lowered their requirements to satisfy the minimums. Why would the private school lower its standards? I believe the answer lies in the fact that nearly all K-12 private schools are non-profit. Their operators do not strive to enlarge their market share or attract additional “customers” beyond what they need to breakeven. Their modus operandi is to be good enough to attract sufficient students and revenues to stay afloat. Since their main competitors are the public schools, they tend to have their performance tied to that of their public counterparts. They need to be better but not that much better.

I’ve begun this discussion with the theme of “Dumb and Dumber” to make plausible two primary assumptions that will support what follows. They are:

1. Children, on average, are capable of learning a great deal more than is currently required during the K-8 years.
2. Enterprises that operate without a profit motive tend to be inefficient. This means they provide goods and services of marginal quality for excessive prices. Both public and most private schools are non-profit. The latter tend to be somewhat better as they must avoid insolvency (a weak form of the profit motive).

Adam Smith on the Economics of Education

Economics, as a discipline, has been around for more than two centuries since its founding in the late 18th century by the Scottish philosopher Adam Smith. Even at that time, the economics of education was considered a worthy topic by Smith and he addressed it at some length in his famous book, “The Wealth of Nations,” originally published in 1776.²

In his time there were not organized systems of public education. Schools were nearly all private but their funding mechanisms varied widely. Smith observed that the quality of the educational product depended on how the school was financed.

His argument stressed that teachers perform best when they are paid directly by the student or parent. Alternative arrangements in which teachers were paid from endowments, public funds, or land rents did not provide the same incentives for good teaching. He recognized that altruism, though a positive incentive, was a weak motivator compared to the pecuniary interests of the teacher.

Smith was a professor at the University of Glasgow where it appears students paid professors directly for their instruction. In comparison he had the following to say about a rival institution where many teachers were totally funded from public endowments: "In the University of Oxford the greater part of the public professors have, for these many years, given up altogether even the pretence of teaching." He should know as in his youth he spent six years studying at Oxford.

In his time private schools giving instruction in fencing and dancing were entirely supported by student fees while in comparison riding academies tended to be supported by public endowments. He claimed that students in the former institutions would adequately learn fencing and dancing while those in the latter would not learn much about riding.

Of Smith's observations, probably the most relevant to 21st century education is his discussion how competition between subsidized teachers and purely private ones tends to drive the latter out of business. This is caused by the tendency of consumers to prefer a lower quality good if it is free or heavily subsidized. That, in turn, hinders the success of the private vendors.

Education in the Socialist Era

Smith's ideas about education and economics (and those of other advocates of free markets), in general, did not generate enough adherents to overcome historical trends moving in the opposite direction. Not long after the time of Adam Smith, a variety of new governmental institutions were established in Western countries that eventually came to be known as socialist institutions. The socialist view, typically, advocated that goods and services might be better provided by the government instead of private suppliers. It was seen essential that government both fund and run these services.

One of the first socialistic institutions to appear was that of compulsory public education. It was first introduced in Prussia in the first decade of the 19th century. Based on the Prussian model, public education was established in the United States, first in New England in the mid-1800's, under the leadership of Horace Mann and others.³ A primary motivation for the introduction of public education, aside from its supposed efficiency, was its ability to instill government favored propaganda, civic values, and generally the Protestant ethic. That was certainly the case in Prussia and demonstrably a primary motivation for developing public education in the United States.

As the 20th century drew to a close, it was abundantly clear that socialism was a failed system. The socialist institutions were inefficient and inferior to privately run alternatives. Many of them were dismantled—particularly in those governments that had widely adopted socialism as their economic system. In the United States, socialism had not progressed as far as in other societies but had dominated some economic sectors—education being a prime example. The one clear advantage of socialist institutions was their tendency to provide universal benefits. Economists of the 20th century began to look for alternatives that would retain universal benefits while providing the incentives for a higher quality product at lower cost.

When diagnosing what was wrong with public educational systems, analysts identified bureaucratic inefficiencies as well as teacher union interference as two primary causal factors.⁴ Moreover, there was often no mechanism within the public education sector for its customers to choose the educational services (in terms of variety and quality) that they desired.

The Influence of Milton Friedman

Was it simply the musings of an Ivory Tower economist at the University of Chicago that first introduced the concept of “vouchers” into the tool kit of educational reformers? Or was it also the wretched Chicago slums that surrounded the campus and the nearby derelict public schools that posed a crisis in education? I don’t know. But we do know that in the mid-1950’s economist Milton Friedman proposed a system of school choice based on publicly funded vouchers.⁵

Friedman, Noble Laureate and well-known advocate of free-market economics, sees vouchers as a mechanism to open educational services to a robust marketplace where the quality, quantity and variety of educational options can expand. He understands that through the mechanism of Adam Smith’s “invisible hand” the societal goals of better education at lower costs will be achieved at the same time that the consumers and providers of education benefit too. Additionally, he believes that the marketplace will put pressure on the government schools to improve or face a loss of customers.

In the view of Friedman, probably one of the greatest benefit of vouchers will be the introduction of new private schools of many varieties. These schools, under the present circumstances, have little hope of development. As Friedman put it, “Try selling a product that someone else is giving away!”

Another point made by Friedman⁶ regards the possible harmful effects of the propaganda taught in government schools. Public schools tend to promote issues from the point of view of the political left including advocacy of socialism, unions, and moral relativism. Even the best intentioned public school may teach values inconsistent with those of some parents. The only solution for such parents is the availability of a private school that promotes moral and political standards consistent with their own.

Exceptional Competitors

I have tried to make the point that it is difficult for an enterprise to compete against a subsidized supplier. Difficult but not impossible. The mere fact that private schools have about 11% of the K-12 marketplace proves that parents will pay for alternatives to subsidized public education if they see a significant additional benefit from doing so. It would seem that if those additional benefits were suddenly of a much greater magnitude at no higher cost, other parents would make arrangements to enroll their children in such exceptional private schools as well.

Our current “crop” of private schools are almost entirely run by non-profit charitable organizations. As such they generally suffer from the inefficiencies associated with the non-profit sector of our economy. This means higher costs for a sub-optimal product. We believe that more customers would enter the educational marketplace if the quality of private schools could be improved without raising their costs.

As a related example, for many years the Post Office maintained a monopoly over the delivery of mail and parcels. However, in recent years, private companies such as Federal Express have found ways to capture a segment of that market. The quality and reliability of their overnight package delivery services has even attracted customers who use it to send letters and other documents. This service is in direct competition to the First Class mail service provided by the US Postal Service and at a price about ten times higher. I present

this example only to show that if you are superior enough, you can compete with a heavily subsidized or even free service.

This brings us to restate our goal: We believe we can establish private for-profit schools in the K-12 marketplace that will be of such extraordinary quality that they will capture a significant fraction of that market. The economic analysis suggests success if we can design such a school. Before we can consider how we might design such schools we examine what lessons can be learned from the home schooling industry and then take a look at the handful of for-profit schools that already exist.

Lessons from Home Schooling

Home schooling is not new. It has existed throughout history and presumably in the prehistoric periods as well. Formal instruction whether from private tutors or in a classroom format has also existed in various forms over the centuries. Within the United States, it is only within the past two centuries, that universal access to a formal education has been made available. Government funded education, most often in the form of public schools, made this option a reality for all. In our own time roughly 87% of children attend public schools, 11% attend private schools, and at least 2% are educated at home either by their parents or by the employment of tutors.⁷

The reasons parents have chosen home schooling have varied. In the case of child professionals (such as actors, circus performers, or participants in a family business) home schooling was the most convenient format- mainly for scheduling reasons. Other parents, for economic reasons, chose home schooling when they could not afford a private school and yet wanted better educations for their children than what the local public schools provided. Some did not have the type of school they preferred available in their area. Still others wanted their children protected from unsafe conditions.

Our reason for discussing homeschooling is not to advocate that format- although that may be a good choice for some parents. Rather we are inspired by the fact that, on average, homeschooled children have excelled not only beyond the attainments of publicly educated children, but also beyond those attending most private schools. As Milton Friedman once put it, and I paraphrase, when the cottage industry produces a better product at lower cost than the factory, it says something about the factory.⁸ I suppose one could quibble over the cost of homeschooling because of the large opportunity cost for the parent doing it, but the observation still suggests that schools (the factories), both public and private, might learn something from a review of the methods employed in home education.

Just what is known about homeschooling that can inform our discussion? There is not an abundance of research in this area so drawing conclusions is risky. Yet, there is enough data to make some plausible conjectures. To date, as far as I am aware, the most extensive compilation of research data comes from the study by Rudner where he reviewed the achievement test scores for approximately 20,000 homeschooled children and compared them to students attending public and private K-12 schools.⁹ Rudner notes that his analysis is limited by unknown sample data bias of the homeschooled population because the sample may not be representative. And it may be that the most underrepresented part of that population in that sample could be the lower performing homeschooled students. Still the sample size is large and the results for the purposes of our discussion are probably adequate.

Rudner provides data for the 12 years from 1st grade through 12th grade. For our purposes, however, we are more interested in the cumulative benefit of education than the year-by-year results so we shall focus on 8th grade and 12th grade results only. While Rudner provided the test results from the curricular areas of reading, language, math, social studies and science we restrict our discussion to the composite scores only. The table

below summarizes the percentile results for the nation, for private schools, and for homeschools. We also estimate the median percentiles for the public schools:

Percentiles	8 th Grade	12 th Grade
Home Schools	81	86
Non-Profit Private Schools	72	74
National	50	50
Estimated Public Schools	47	46

Table 1. Home-schooled children get top scores

Perhaps more illuminating is to cast the scores in terms of grade level equivalents. Again for the 8th grade children and 12th grade children we display these results in a table:

Grade Equivalents	For 8 th Graders	For 12 th Graders
Home Schools	12.9	>>13
Estimated Non-Profit Private*	11.1	>13
National	8.8	12.8

Table 2. Home Schooled Children are Four Years Ahead

These tables suggest, as would seem reasonable, that if private schools are superior to public ones and if homeschools are correspondingly superior to private schools that the margins of superiority expand as time progresses. The really important conclusion for our purposes is that a homeschooled child in his 8th year of study will have achieved as much as the average child in his 12th year of schooling. If there is a way to replicate this advantage in the context of a truly exceptional private school, our goal of a KP school where children are college ready after their 9th year of schooling seems reasonable.

Let us now turn to explore some of the causal factors favoring home schoolers. Is the success of homeschooling simply the result of the individual attention given to each child? Is it the result of superior books and other learning aids? Or is it a combination? It would seem that it is both but what evidence is there to confirm this? Actually, Rudner provides some evidence that the learning aids have a minor impact. He suggests that individual attention is a critical factor. Are there good ways to provide this in a private school environment? Let us explore these questions.

- Individual attention. Rapport with the parent instructor. Is it something unique about the love relationship between parent and child that gives the advantage or is it more generally the care paid to the child's learning process by surrogates such as teachers, tutors, volunteer helpers, or older students? It is not clear whether this advantage of homeschooling can be duplicated in a school environment. This, in some sense, is the motivational element and while the incentives a child has at home may not be available at the school, it may be possible to substitute other motivating factors to produce a similar effect.

· By interpolating the results from Rudner's paper we derive a crude estimate for public school achievement.

· We obtained these estimates by measuring Rudner's graph for private schools (in his Figure 1)

- Individual needs. Tailoring the content and instructional methods to match the student's interests and learning skills is obviously an aspect of homeschooling and it would seem that an appropriately structured private school could do the same. Satisfying the child's individual needs may be accomplished by a number of means not requiring the constant participation of the teacher. So for example, books, computer based instruction, multi-media materials, distance learning, and peer interactions can address such needs without the direct participation of the teacher. Obviously, the teacher's skills will be required to further monitor and assist the child but the teacher's time devoted to this aspect may be but a fraction of the time the student devotes to his or her studies.
- Superior learning aids. While Rudner found that learning aids made little difference in the home schooling environment, they may be much more important in the private school environment. Thus having access to books and other learning aids (such as may be obtained on the computer) may be critical.

To replicate the successes observed in the homeschooling environment within the context of private schools could conceivably be accomplished by a number of different approaches. On the one extreme one could try to copy the one-on-one intensive "tutoring" style that defines homeschooling. Or on the other extreme one could try to automate the process without losing the key advantages of homeschooling. Homeschooling, as noted earlier, is not inexpensive when the opportunity costs are factored in. The labor-intensive nature of homeschooling is not going to be profitable if imitated in a private school situation.

It may be that some of the one-on-one aspects can be captured by the use of volunteer teaching assistants or by the use of more advanced students interacting with the pupils. It may also be possible to automate a sufficient number of traditional teacher chores so that the teacher will be able to devote a much larger portion of time to individual interactions. Distance learning, movies, lessons on computer media, and large special purpose assemblies are examples of ways to conserve instructional time. Abandoning the rigid structures of grade levels, of doing everything as a class, and of reinventing educational materials that already exist can also help release valuable resources to be used in more productive ways.

I should caution the reader that this draft review is preliminary and may have omitted important developments and facts of which I am unaware. As we bring new information to the analysis, that could influence or alter the conclusions that we will eventually make.

For-Profit Vanguard

We now return to the discussion concerning the economics of K-12 education. We earlier pointed out that among public, non-profit private, and for-profit private schools, the former is generally the least efficient while the latter is the most efficient. The fact that most suppliers of education are primarily public or non-profit private does not reflect their economic advantage so much as they reflect the institutional inertia from the era of socialism. It will take time to overcome these wasteful traditions, but I believe a combination of privately led innovations and public policy reforms will eventually succeed. The core emphasis of this report is to elaborate upon the former and to suggest what can be done in the for-profit private sector to advance K-12 education.

If we regard the "retail" level of education to be the schools themselves, then only a tiny fraction of the education industry is for-profit private. However, if we look behind the scenes and consider all the various contractors and vendors involved- including book publishers, computer and software vendors, contract workers, school operators, and management consultants- the for-profit sector constituted about 10% of the education marketplace in the year 2000.¹⁰ The people who are in the business of providing capital to this industry have estimated that the for-profit education industry would grow at approximately 13% annually.¹¹

An important development in the past several years has been the growth of the EMO (Education Management Organization) industry in which private for-profit companies operate public schools under contract. According to a fairly recent compilation (circa 2002) from the Reason Public Policy Institute, there were in excess of 418 public schools being operated in this manner.¹² Edison Schools, Inc. is perhaps the best known and is the largest operator with approximately 113 schools in operation. The Chairman of the Board of Edison Schools is Benno Schmidt, formerly the President of Yale University. I would describe the Edison Schools operational format as “turn-key.” While every school setting will have its own unique problems, the Edison format is generally sufficiently flexible to accommodate them. The Edison curriculum and teaching methods are based on thoroughly vetted research conducted by such institutions as the University of Chicago and Johns Hopkins University.¹³ Needless to say, teachers’ unions and other others in the public education establishment have been applying considerable political pressure and tactics of questionable legality to have Edison’s contracts terminated or prevented from being initiated. As a result Edison has had significant legal expenses and suffered other losses in connection with such political skirmishes. This has impacted its profitability; it has yet to report a profit.

If Edison were to close as a result of bankruptcy they would not be the first EMO to suffer that fate. Tesseract Schools- which absorbed EMO Education Alternatives- was liquidated last year. It is not clear whether Tesseract’s failure was primarily its own responsibility or was it made unprofitable by the tactics of its political opponents.

Certainly impediments to the EMO type of operation are the bureaucratic constraints and interference that limit the flexibility of the contractor to operate in an optimal fashion. We now turn to review for-profit schools that stand alone, undisturbed by the public school systems. In theory the additional flexibility enjoyed by these schools should allow a more efficient operation. Of course, efficiency means more profits on the one hand and a better educational product on the other, if, of course, the implied savings are shared between these two “goals.” As with all for-profit enterprises the long-term return depends not only on short-term profits but also on providing an attractive product that maintains and enlarges the company’s market share. Thus, the for-profit school will necessarily seek to balance the two needs of profits and better products to find a sustainable optimum.

Before looking at for-profit K-12 schools, it is useful to look at for-profit post-secondary education where the ability of vendors to make good profits while providing valuable educational services is routine. Two good examples are the DeVry Institute and the University of Phoenix operated by the Apollo Group. DeVry has been in this for-profit education business for over 70 years. I remember well, as a child growing up in Chicago in the 1950’s, receiving mail solicitations from DeVry to enroll in their various “technology” courses. DeVry began as a trade school providing instruction primarily in the electronics field. This company has evolved over the decades to become a full-fledged college that offers a BS in some technical fields. DeVry also offers courses to candidates for the CPA certificate and for the CFA charter. I also know this well as I recently took a course from DeVry in my efforts to obtain a CFA charter. It was a thorough and well-structured course and used computer technology to great advantage in preparing students for the CFA examinations. The point here is that DeVry is a profitable company. Similarly, the University of Phoenix provides a rather vast system of campuses and correspondence schools that enable undergraduate students and others to pursue degree and/or certificate programs. The tuition at the University of Phoenix is typically less than that of a comparable college and yet its quality of instruction is above par. As with DeVry, the University of Phoenix and its parent, the Apollo Group, have been profitable for many years. Both have been growing rapidly. The conclusion to be drawn here is that for-profit post-secondary education is not only feasible but it is a healthy and growing part of the education industry.

I raise the issue of the post-secondary sector to make the analogy that the general strategy in that area should carry over to the K-12 sector. It seems the reason why the post-secondary for-profit industry is healthier than the current K-12 industry relates to the fact that the post-secondary marketplace has always had much more choice in it and therefore much more competition. As we already noted we see two efforts that will help open up the K-12 market: The greater availability of scholarships (read vouchers) and the effect of the entrance of stellar schools. We see a symbiosis of these two trends that should help accelerate the evolution of the presently “oppressed” K-12 marketplace towards a larger and healthier one. As I mentioned earlier, the purpose of this report is not direct advocacy of vouchers. However, we do recognize the political inevitability that if “stellar” schools become available there will be much clamoring by politicians’ constituents to find the means (scholarships or vouchers) by which their children can attend such schools.

As of this writing there is a small marketplace in scattered geographic locations where parents can choose a for-profit school. The “epicenter” of this new industrial sector is in and around San Jose, California. Two companies, Challenger School¹⁴ and The School of Choice¹⁵, were founded in San Jose. Challenger School has been in business for approximately 40 years and now operates 24 schools in California, Nevada and Utah. It is now headquartered in Utah. Challenger schools are not inexpensive but are priced to be somewhat less expensive than typical pricey private non-profit academies. I believe their middle school tuition, in one market, is \$8,400. As with other private businesses they sought and have “pricing power.” At many of their schools, people have camped out over night to retain their position in the first-come first-served registration lines. It’s no wonder they are so popular when you realize that their scores on the Stanford Achievement tests averaged near the 90th percentile. (Specifically, 88th for grades K-2 and 92nd for grades 6-8). The School of Choice is a new entrant and operates one school that has been besieged by parents wanting to enroll their children for reasons not unlike those given for the Challenger School.

The total number of for-profit private schools within the K-12 range is not known. However, there is an association of schools that limits its membership to for-profit entities: The National Independent Private Schools Association (NIPSA). According to its Website, www.nipsa.org, there are well over 100 members in the United States. The US Department of Education does not currently maintain records that allow one to differentiate for-profit schools from non-profit ones. Thus it is difficult to estimate the total number except to say that it is likely in the low 100’s.

We presented above in Table 1 the percentiles achieved by home-schooled children. For 8th grade homeschoolers were at the 81st percentile. The Challenger School system results for 8th grade were at the 93rd percentile. If other for-profit schools can maintain these kinds of test results, we have a wonderful prospect. Imagine the homeschoolers throwing their hands in the air, closing up shop and sending their kids off to truly superior- what we have dubbed “stellar”- schools!

While the success of these various for-profit schools is encouraging, it is not proof that the K-12 for-profit school industry will blossom overnight. What can increase the odds of success will be careful planning and execution of those plans by new entrants to the sector. I know that there are advocates of free-market education who think our efforts are premature and who think we should be all working on vouchers and other tools to open up the K-12 marketplace. I think that it is difficult to predict the future and it is not clear whether the one approach or the other will stimulate the opening of that market. As an investor I know that one should not put all of one’s “eggs in one basket.” Thus while others push to enlarge the market by increasing the number of customers who can afford tuition payments (through scholarships, vouchers etc.) some of us will try to expand that market by introducing products that are so attractive that penny pinching parents will suddenly open their wallets to better ensure that their children can thrive educationally.

New Options for Public Schools and Non-Profit Private Schools

Let us suppose that a number of for-profit franchise operations or companies become successful. Just as current EMO's are sometimes hired to run public schools, there would be nothing to prevent a public school or a non-profit private school from acquiring a franchise. Religious schools could buy a franchise and then augment the program with its own additional religious classes and activities. In such cases the "profits" of the franchisee would simply add to the organization's endowment to be used eventually for charitable or other educational purposes.

Conclusion

Economics Suggests For-Profit Schools will be Excellent

The experience and theory of economics suggests that the transition of a non-profit activity to a for-profit one will be accompanied by a better quality product at lower cost. If current non-profit private schools can be considered good, this suggests the for-profit counterparts will be better. We say they "will be excellent." We have seen indications that the fledgling assortment of for-profit private schools are indeed considerably better than all rivals, including home schooling.

Design a New Educational Format Around Best Methods and Technologies

The simplest strategy is that of imitation: simply copy what has succeeded in other for-profit schools. However, experience from the homeschooling industry and from post-secondary for-profit education suggests that instructional methods, curriculum, and issues concerning school structure and format can be improved. This will necessarily be an iterative process involving research and development. The likely result will be a further improvement in student learning and performance.

Involve Parents and Others as Volunteers

Given the well-known role of parent "as teacher" regardless of the school's format of operation, for-profit schools should encourage parental participation both at the school and in homework activities. Other interested volunteers should also be encouraged to assist in the labor-intensive teaching chores. In terms of any franchise arrangement, these kinds of involvements would be optional at the discretion of the franchisee.

Tuition will be Less Expensive

Both economic theory and our limited experience with for-profit schools indicate that tuition charges have been and will be somewhat less than non-profit private schools. To the extent the franchise operation serves more and more students, many of the fixed costs will become very inexpensive on a per pupil basis. This would suggest a further diminution of tuition costs.

Getting Started will Require Some Initial Investments and Risk

At this time, little consideration has been given to detailed business plans under which such schools can be developed. However, it does seem clear that the franchiser will first need to build, operate and demonstrate the successful operation of a school before franchises can be sold. (Or the franchiser might acquire an existing school to be modified and then franchised?) These initial steps are likely to be unprofitable requiring seed money. Going forward there is no guarantee any given plan will become profitable. The potential is there for some operators to succeed financially, but others will surely fail. Thus there is risk as well.

Stellar Schools are the Result

We already have fairly convincing evidence that for-profit "stellar schools" are feasible and indeed already exist in a few places. If our assumptions and provisional evidence of profitability are correct, there is the financial dynamic for this for-profit education sector to expand gaining significant market share. Other

forces, such as vouchers will likely accelerate this process. If non-profit schools and public schools are permitted to become franchisees, there is no reason why a system of for-profit schools- or more correctly “several competing systems of for-private education companies”- cannot dominate the K-12 (or K-P) marketplace and at the same time make huge improvements in the schooling our children receive.

Evolutionary Forces may Lead to the For-Profit Format Dominating All Others.

We have seen that in other industries for-profit enterprises generally tend to expand their market share at the expense of their non-profit and government run counterparts when the laws and regulations support an open marketplace. This should be true for the educational industry as well. A number of factors and trends suggest that the marketplace for for-profit K-P educational services is enlarging. These factors and trends include:

- The improving standard of living suggests that more parents will find tuition payments affordable.
- The expectation that more-and-more grants to parents and students in the form of vouchers, tax credits, and other devices will enlarge the consumer base able to make tuition payments.
- The expectation that for-profit schools will have lower tuition charges will also enlarge the consumer base.
- The higher quality of for-profit schools will induce many parents to modify their budget priorities to include provision for tuition payments

These considerations include the age-old concept that “nothing succeeds like success.” Stellar schools are intended to be and by all present accounts are a “success.” It would then seem that we shall “succeed.”

The government could help in other ways as well. Vouchers are a step in the right direction, but “leveling the playing field” by ending public school subsidies would put public schools on the same economic footing as the others. It would not be surprising, in such circumstances, to see public education, “as we know it,” fade away. The public interest, however, would be served in its aftermath if government insured that all students had access to tuition support and if government continued its minimum curriculum standards for private schools already in place. More to the point, the public interest of having well educated children will be served even better when government schools are no longer the suppliers of K-P education.

Triumph or Defeat For Public Education?

Lastly, one could be concerned that if the for-profit sector succeeds too well that it would deprive public schools of significant numbers of students and as a result harm them? As a believer in the benefits of competition, it is more likely that public schools would improve so that the students remaining would receive better educations.

Public schools are also seen by many as the only resource for certain kinds of special needs students. Where will these children go if the public system is put out of business? It would seem however that there are two remedies that will protect such children. First, the private array of schooling options may have appropriate services for these children. Second, if private schools have no facilities for some of these children, it would seem that democratic forces would insure that the public system or some other government program would continue to help them.

But the issue here is not the survival of public education in its present form. Rather the issue is that of superior schools- assuming they can be created. If the evolution of education actually moves towards “stellar” schools, then the mechanics of the marketplace will enhance the competition faced by non-profit private and public schools. This competition will have good results as far as the children are concerned. In one scenario one sees the public schools reinvigorated to such an extent that they gain, rather than lose,

market share. At the other extreme, public schools would lose students to schools considered to be better. In either case the children benefit.

In the preceding three paragraphs no mention was made of government grants, vouchers, scholarships, etc. because the “stellar” schools would have an impact on the marketplace in any case. Admittedly, the impact would be larger in a voucher environment. The remaining discussion will assume that vouchers or some other government financial support mechanism provides school choice to all children.

The possibilities in a fully open educational marketplace in which all parents and students have a choice of schooling are much more extensive than when some are denied choice. At the extreme one could envisage the end of public education as we know it. In such a scenario one can imagine a varied array of private educational institutions providing a myriad of programs and services to children and their parents. The government would still provide a framework for education. I believe its role would be two-fold. It would still maintain minimal standards and regulations such as are required currently of private schools. And it would provide sufficient funding to give all children and their parents the choice over the educational services and the schools to be utilized.

We don't know if the future we envisage can be realized. If the answer is “no” then improvement of education must be sought along other avenues. However, if the answer is “yes” it means a much better educational experience for our children. If those benefits were provided to all children through appropriate government support of education, it would seem that this would be public education at its best. Not public education as we know it now, but an artful combination of what the private and public sectors do best.

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¹³ Lips, Carrie, op. cit., pp. 5-6.

¹⁴ <http://www.challengerschool.com/>

¹⁵ <http://www.schoolofchoice.com/>