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For-Profit Schools Are Making a Comeback

— ◆ —
RICHARD K. VEDDER
AND JOSHUA HALL

Pivate for-profit schooling has grown rapidly in the United States in recent years. In many respects, this development marks the revival of a form of delivery of educational services that has existed for several millennia. In this article, we review the historical experience, assess the present situation, and speculate about possible future trends. We conclude that the future of for-profit schools is relatively bright, despite powerful forces aligned against them.

The Crisis in American Public Education

Before discussing private schools, we need to review the condition of government-provided education in the United States. Others have done so far more comprehensively than we can here (Chubb and Moe 1990; Finn and Ravitch 1987; Hanushek 1994; Hirsch 1996; Lieberman 1993; Stevenson 1992). The evidence is clear that productivity in American public education has been falling in terms of most ways economists define and measure productivity. Caroline Hoxby puts the decline over the past generation in excess of 60 percent (2001, 2). Inputs per pupil have risen in real terms by a factor of two or three over the past four decades, but output per pupil has not risen correspondingly and, by some measures, has declined. Although the measurement of educational performance is a tricky business, only a handful of supporters of the current system of educational delivery argue that productivity is rising or even staying constant (Bracey 1998). One of us frequently tells legislative groups

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that with the possible exception of prostitution, teaching is the only profession we know of that probably has had no increase in labor productivity in the 2,400 years since Socrates was teaching the youth of Athens.

Contemporary American government schools resemble the mode of economic organization prevailing in the Soviet industrial economy of, say, 1970, more than they resemble contemporary American industry. Like old Soviet firms, U.S. schools are government-owned and government-operated enterprises with a good deal of direction from distant bureaucracies. As in the old Soviet system, government-school policymakers historically have measured performance in physical units of output, such as the number of students enrolled or graduating, rather than by qualitative measures such as learning per pupil or indicators of student or parental satisfaction. As in the USSR, consumer sovereignty is essentially an alien concept, especially among the poor living in central cities. The customers are often treated indifferently, if not with contempt. Like the old Soviet managers, government-school administrators have few incentives to reduce costs per unit of output, and in any case political forces keep them from radically altering the mode of service delivery in order to introduce market forces or otherwise enhance efficiency.

Within five years of the October Revolution in Russia, Ludwig von Mises ([1920] 1935) was arguing that rational economic calculation was impossible in a socialist economy, and he predicted many of the woes that would beset the Soviet economy during the seven decades of its existence. Although a review of the socialist-calculation debate lies beyond the scope of this article, we can note that even opponents of Mises, such as Oskar Lange and Fred Taylor ([1938] 1964), recognized the need for the introduction of prices and market-style incentives in order to overcome the calculation problem. Many of today's so-called radical reformers accept the central role of government in education and merely want to do in the schools what socialists such as Lange and Abba Lerner would have done in a command economy such as the Soviet Union.

Ultimately Mises and F. A. Hayek were proven right, and communism died in Russia with a whimper, not a bang. Will the government schools of the United States, which in so many respects mirror Soviet economic organization, meet the same fate? U.S. education may be less rigidly socialist than the old Soviet enterprises, with approximately 15 percent of education provided by private-school alternatives, but even the Russians had their private vegetable plots—the Soviet agricultural equivalent, perhaps, of home schooling in contemporary U.S. education. More important, nearly the entire Soviet economy suffered from socialist inefficiency, whereas in the United States the relatively inefficient educational system receives ample subsidies from the large, efficient private sector.

Nonetheless, lessons may be learned from the socialist-calculation debate. Government schools are becoming extremely costly in relation to services they render. The inability or unwillingness of entrenched monopolists to change their ways, given the apparent lack of adverse financial consequences for inadequate performance, has

doomed some well-meaning but inherently inadequate attempts to reform existing modes of service delivery. Hence, dissatisfaction with the status quo will probably continue to grow, eventuating in calls for more radical change. This outlook brightens the prospects for private for-profit schools.

Five Trends Favoring For-Profit Education

Five trends arguably presage marked expansion of private education in general and of for-profit education in particular.

First, barring some unanticipated disaster, real incomes will continue to rise over the long run, and the demand for high-quality education is fairly “income elastic.” The move to the suburbs has no doubt been significantly affected by the desire of parents to move their children from mediocre central-city schools to better suburban ones. Schools that are perceived to be good create higher property values in their vicinity, a sign that school quality itself is highly valued (Bogart and Cromwell 2000; Oates 1969). As incomes continue to rise, parents will continue to strive for better education for their children, and the price resistance associated with paying the significant private marginal costs associated with private-school tuition may decline. The increase in demand for private education will likely induce a supply response, as private entrepreneurs perceive growing profit opportunities. Given the relatively high-price elasticity of demand for private education, the augmented supply should lead to significant increases in equilibrium quantity. The rapid growth of for-profit education in the past few years, to be discussed shortly, is consistent with this hypothesis.

Second, a pronounced movement has taken place within the public-school system to reduce spending differentials between schools, typically resulting in successful lawsuits to declare existing funding mechanisms unconstitutional. As it so often does, California led the way in this movement with the *Serrano v. Priest* decision more than two decades ago. Although economic theory is ambiguous as to the effects of school-finance equalization, considerable empirical evidence indicates that attempts to force funding equalization reduces political support and hence funding for public schools in the long run (Fernandez and Rogerson 1998; Silva and Sonstelie 1995). Where such equity efforts are successful, suburban parents, who are the backbone of support for public education, become potential supporters of emerging for-profit private schools if they perceive that the “good school advantage” for their children is eroding.

Third, public schools are popular in part because the private marginal explicit cost of attending is close to zero—that is, because others are compelled to subsidize the consumers. The willingness of the non-school-age population to submit to financing such subsidies depends in large part on a perception that such expenditure serves the social good. As evidence mounts that private schools offer better education at lower true marginal costs to society, political support for public-school subsidies may decrease. The increase of the proportion of the elderly in the population enhances the erosion of support for government schools.

Fourth, and related to the third point, the growing realization that private schools operating in a competitive environment are more efficient adds to the public willingness to shift public funds to subsidize *private* education. The success of voucher experiments increases this support. The move in many states toward tuition tax credits, charter schools, and public support for home schooling also shows that public policy may work to reduce the marginal private cost of private schooling. We must add the caveat, however, that schemes such as tuition tax credits increase the demand for private education and therefore have the immediate impact of raising prices, thus partially reducing any intended benefit.

Fifth, over the past sixty years, the number of public-school districts has declined significantly, from more than 119,000 in 1937 to fewer than 15,000 today (Kenny and Schmidt 1994; NCES 2001, table 87). This reduction has led to some decline in the accountability of public schools because of population movements motivated by differential tastes for public services (Hoxby 1998; Tiebout 1956). Moreover, it may have promoted inefficiency and poorer student outcomes (Niskanen 1998). The ability of parents to influence educational decisions has declined as they have grown more distant from major decision makers, such as the local school boards and, increasingly, even state-level bureaucracies. This shift has probably contributed to increased parental dissatisfaction, boosting home schooling and the charter-school movement. Many charter schools are either owned or managed by for-profit firms.

The Recent Growth of For-Profit Education

Substantial evidence indicates that the for-profit education industry is growing dramatically, far outpacing the growth in the economy. We downloaded the information on all thirty-four companies in the Yahoo Finance “schools” category. One of these companies is predominantly Canadian; another is almost entirely owned by another company, and therefore we eliminated it from our data set in order to avoid issues of double counting. The remaining thirty-two companies had a market capitalization of more than \$15.4 billion as of mid-June 2001. This is more than double the capitalization that existed less than two years earlier (Vedder 2000, 21). This difference suggests that the market capitalization has risen by approximately 50 percent per year for at least the previous two years. Such a high rate of increase cannot be explained by the robust performance of equity markets in general during the same period. A majority of the companies in question are traded on the NASDAQ, whose overall average *declined* by 25 percent in that two-year period. Even the Dow-Jones Industrial Average was essentially flat over this interval.

Part of the growth in capitalization reflects new ventures in for-profit education. In August 1999, the Yahoo Finance schools list contained twenty-two companies; by June 2001, the number had grown to thirty-four. As in virtually all booming fields, the financial success of these companies varies dramatically. Eighteen of the thirty-two companies that we examine reported after-tax losses over the previous

year. Some were in, or teetering near, bankruptcy. In contrast, others were spectacularly successful.

The thirty-two for-profit firms had sales over the previous year of more than \$6.1 billion—almost one percent of total education spending. Less than two years earlier, the trailing-twelve-months sales of the for-profit schools came to only \$3.9 billion. On an annual compounded basis, sales collectively rose approximately 25 percent. From 1998 to 1999, sales rose approximately 22 percent, suggesting that for at least three years the revenues of publicly traded for-profit school companies rose at a compounded annual rate of 20–25 percent. That market capitalization has been rising significantly faster than revenues suggests several possibilities, the most plausible being that investors have become more bullish about the industry—an external validation of the arguments we made earlier about the likelihood of rapid future growth.

Although generalization about the for-profit firms is dangerous, given their great diversity of size, degree of success, and even type of product delivered, almost all of them have one aspect in common: they are controlled by a small group of insiders. In only one of the thirty-two companies do insiders own less than one-fourth of the company; in twenty-two cases, they own a majority of the outstanding stock. Although the companies are typically small, fourteen of them had annual sales of more than \$100 million. No company had sales of as much as \$1 billion.

Statements about industry growth and profitability must be evaluated cautiously because a significant portion of for-profit schools consists of privately held companies. One estimate of the total size of the industry, made in 1999, suggests that perhaps half of the capitalized value of for-profit school companies is held privately (Buckeye Institute 1999; Vedder 2000). Moreover, the total might be even greater if one counted all the textbook suppliers, transportation companies, food-service organizations, and so forth that sell products to public schools. For example, Vivendi paid \$2.2 billion recently to purchase Houghton Mifflin, a company that derives a majority of its revenue from the school market.

Of the thirty-two Yahoo Finance school companies examined, most are providing services outside the traditional K–12 market in which public schools operate. Some operate in the preschool market, others run for-profit colleges and universities, and still others offer nondegree vocational training in diverse subjects ranging from music to the culinary arts. Still others offer supplemental education for students attending K–12 public schools. Finally, a few actually run for-profit private schools that compete with government schools and nonprofit private institutions.

The most financially successfully company by far has been Apollo Group, the owner of the University of Phoenix and other for-profit institutions. At the beginning of the traditional 2000–2001 academic year, its total enrollments exceeded one hundred thousand. In the 2002 fiscal year, Apollo should earn more than \$100 million in after-tax profits. Its market capitalization has doubled in the past two years and now exceeds \$4 billion. Its pretax profits approach 20 percent of revenue. Apollo has spun off University of Phoenix Online as a separate company, which it still controls. That

company is likewise immensely profitable; it has a market capitalization of approximately \$2 billion. Apollo now offers degree programs in most states and in Puerto Rico.

Companies worth \$3 billion (by capitalization) that are strong in vocational educational services for high school graduates are Career Education Corp., DeVry, and ITT Educational Services. All are highly profitable, growing rapidly, and provide private job training mainly for high school graduates, although DeVry, the largest of the three, also offers university degrees and even postgraduate training.

At the other end of the age spectrum, KinderCare Learning Centers provides educational services to more than one hundred thousand children between the ages of six weeks and five years, although recently it has become active in the market for prime school ages (five to eighteen). With sales of more than \$700 million annually, the company is moderately profitable.

The financial success rate of private for-profit schools competing directly with government-run schools in the five to eighteen age bracket is far lower, but revenues have grown substantially. The most publicized enterprise, Edison Schools, has a former president of Yale University as its board chairman. Its market capitalization exceeds a billion dollars at the time of this writing, and its revenues have been rising 50 to 100 percent a year. The company continues to lose money, however, at the rate of about 10 percent of sales. Nevertheless, its stock price has risen significantly since its IPO in late 1999, suggesting that the market believes that the falling loss margins, reflecting economies of scale, should result in positive profits in the not too distant future. Nobel Learning Communities, which opened the 2000–2001 academic year with 162 schools serving twenty-seven thousand students, is already profitable, earning small profits (its return on equity is less than 5 percent) but continuing to grow rapidly. Rapid growth, however, has been the undoing of some ventures, most notably Tesseract Group (formerly Educational Alternatives), which is essentially bankrupt.

Why are the educational providers operating outside the traditional K–12 market often highly profitable, whereas those competing with the public schools are typically in a more precarious financial condition? We suspect that at least five factors contribute.

First, the private incremental cost of attending a K–12 for-profit school typically amounts to \$6,000 or more because government schools charge no tuition. The for-profit schools, in order to make a profit, not only have to operate at lower cost per pupil than public schools do, but also have some expenses that public schools do not have, such as marketing expenses and taxes. By contrast, the differential marginal private cost of attending for-profit universities is often less in an absolute sense and certainly so in some relative sense, especially if all opportunity costs are taken into account.

Consider a hypothetical high school graduate with three choices: working at an unskilled job for \$15,000 a year; attending the local state college at a cost of \$4,000 annual tuition and fees; and attending a private for-profit university at a cost of \$8,000 per year. The full marginal economic cost of attending the state-subsidized

college is \$19,000 annually (\$15,000 in forgone income plus \$4,000 in tuition and fees), only modestly less than the \$23,000 marginal cost of attending the for-profit alternative. Second, the average earning gain associated with having a college degree is substantial, and students can rationalize attending a for-profit school as a good financial investment in human capital. Third, cash-flow problems are eased by the government's program of guaranteed student loans. Implicitly, the government offers disguised voucherlike assistance for students attending private for-profit universities that it does not offer to children at the K–12 level. Fourth, in public universities, enormous cross-subsidization occurs for graduate education and research, activities not provided in the for-profit schools. Therefore, a public university might have average costs per student of \$10,000 and charge tuition of \$4,000, although the true marginal explicit cost of educating an undergraduate might be only \$4,000 (hence, such students receive no subsidy), whereas the marginal cost of educating a graduate student who pays the same tuition might be \$20,000 or more (hence, such students are heavily subsidized).

Fifth, traditional colleges and universities, both public and private, engage in substantial price discrimination through their scholarship programs. Although some of this discrimination may be made with the same financial motive that leads profit-maximizing entrepreneurs to price discriminate in other industries (for example, the airline industry), some of it springs from other sources, such as a desire to attract good students, achieve a certain racial composition, and so forth. Such price discrimination leads to a higher “sticker” price than would otherwise exist and lowers the explicit differential marginal cost of attending a for-profit university.

Milton Friedman has raised with us the question of why private (for-profit or not-for-profit) schools have not been created to compete for students rejected by the most selective private schools.¹ We suspect that such students apply to prestigious schools such as Phillips Exeter Academy, but they view the public schools in the well-to-do suburban neighborhoods from which most of them come as acceptable “second-best” substitutes—better than some upstart private school without a tradition of excellence but with a high tuition. A reputation for academic excellence cannot be created overnight.

Returning to Our Education Roots

The move toward for-profit private schools is reviving the method of providing education that was common, indeed typically dominant, for at least two thousand years (Coulson 1999, 38–51).² Popular mythology has led people to believe that prior to the establishment of government schools in the nineteenth century, relatively few people could read and hardly anyone but the rich obtained schooling. This myth

1. E-mail correspondence, July 31, 2001.

2. This section draws heavily on Vedder 2000.

maintains that the establishment of taxpayer-financed education led to a sharp rise in literacy and contributed to greater economic opportunity because the poor as well as the rich then learned to how to read, write, and perform mathematical calculations and thence obtained diverse, economically valuable skills.

In reality, long before public schools began, educational attainment was rising, in large part because of learning that occurred in for-profit schools or with private tutors. Moreover, according to widespread opinion, public schools would offer an inferior education, as indicated by Adam Smith: “Those parts of education, it is to be observed, for the teaching of which there are no public institutions, are generally the best taught” ([1776] 1998, 875). There was hardly any public funding of primary and secondary schools in England before 1830, and most funding was private as late as 1870. Yet during this period, the Industrial Revolution occurred; England became the world’s leading economic power; and literacy expanded dramatically. For example, from 1818 to 1834, for the most part a period of no public support, school enrollments rose from 478,000 to 1,294,000. Literacy is estimated to have reached 80 percent by 1870, the end of the era before government-sponsored public schools operated on a regular basis in England (Crafts 1998, 195; West 1994, 172). Private education, much of it for profit, made England a nation of literate persons. David Mitch’s careful analysis of these changes is consistent with Smith’s observation: private schools seemed to have a strong positive effect, but the effect of government involvement in education was actually *negative* with respect to male literacy and trivial with respect to female literacy (1992, 147–49).

The American experience was more complicated, owing to the federal system of government, but the essential pattern is the same. Until the second third of the nineteenth century, most Americans had primarily private schools; some of them run on a for-profit basis. (The one major exception was New England, which early on had a large number of government-run schools.) In New York City in 1820, for example, the Free Society schools were privately run but received considerable public monies, but three times as many students attended pure private schools, many of which operated on a for-profit basis (Ravitch 1974, 19).

In the second quarter of the nineteenth century, the common-school movement took hold in much of America, although even in 1850, less than half of educational expenditures came from government sources. That proportion had risen to approximately two-thirds in 1870, by which time the government schools had become the dominant institution of basic education. Progressive educators and historians such as Ellwood Cubberley (1934) and Merle Curti (1959) have generally portrayed the common-school movement as a successful effort to extend literacy and to reduce differences in educational opportunity in a matter consistent with American egalitarian ideals and the promotion of democratic values.³

3. For a good discussion of alternative interpretations of the common-school movement, see Spring 1986, chap. 4.

Impressive evidence indicates, however, that this view is misguided. Many, including Carl Kaestle (1983), have argued that Anglo-Saxon Protestants, worried about the impact of the mass immigration of Roman Catholics on American values, pushed for public schools in order to preserve Protestant values. Michael Katz goes further, arguing that the common-school movement was the product of “a coalition of the social leaders, status-anxious parents, and status-hungry educators to impose educational innovation, each for their own reasons, upon a reluctant community” (1968, 218). One of the most insightful observers of the age, Herbert Spencer, predicted that the socialization of education would have adverse effects. “[W]e may be quite sure,” he wrote, “that a state education would be administered for the advantage of those in power rather than for the advantage of the nation” (1877, 371–72).⁴

One thing seems fairly certain: the rise of the public school did little or nothing to extend the educational enterprise initially. Performing a statistical regression analysis using 1850 census data, we could find no statistically significant positive relationship between school attendance and public funding (see also Cremin 1980). In Massachusetts, the rate of school attendance scarcely changed from 1840 to 1880 despite a great expansion of public schools (Kaestle and Vinovskis 1980). The notion that private schools were havens for the children of the elite in the era before government-operated schools has no foundation. As Joel Spring has observed, “Private schools were attended by a variety of children from different social classes because a practice existed of adjusting tuition according to the income of the parents” (1986, 52).

The leaders of the common-school movement, such as Horace Mann and Henry Barnard, philosophically supported strong governmental action to correct perceived human weaknesses; they exulted in the power and prestige associated with directing or advising large, centralized school systems. The Whig Party favored public schools, adopting the paternalistic perspective that educated elites could improve the moral and educational environment of the less-enlightened and less-affluent people. The fear of cultural pollution by Catholic immigrants allowed such activists to tip the balance of political power in favor of public schools, despite evidence that the private system worked well. The rise of public schools sprang more from the rent seeking of elites and from the rational ignorance of the masses than from any generalized public dissatisfaction with a system of education that had already allowed nearly all free adults to become literate in the economically advanced countries.

Conclusion

For-profit education has a bright future in the United States, despite the enormous government subsidies of public schools and the opposition to private schools by powerful interest groups, such as public-school teachers’ unions. Several factors point to

4. For additional insight into the thinking of opponents of public education in the nineteenth century, see Richman 1995, 59–70.

future growth. The growth in the past several years has bordered on explosive. In a sense, individuals are beginning to reverse the move toward the socialization of education led by small groups of influential individuals more than 150 years ago. Now, for-profit education's time has come.

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