

School Choice

Encouraging New and Better Schools



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Lessons from the Private Sector

Making Private Schooling Less Expensive

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Introduction

For all of the sound and fury accompanying the expansion of the school choice movement over the past two decades, the results have been distinctly modest. A circumspect analysis of public and private school choice shows attenuated growth in enrollment and marginally statistically significant increases in achievement. Voucher programs assist a meager .5 percent of America's school-aged children.¹ Choice proponents point out that of the 12 random assignment tests of choice 11 show that it has a positive effect on student achievement. But an author of one of those studies, Matthew Chingos, has a more sober analysis of the results: kids aren't making big gains, but at least "there's no evidence that people are being harmed."² Corner a school choice advocate and press him to justify the time and energy he has put into disrupting the status quo, and within minutes he might very well echo Secretary of Education Arne Duncan, who said, "We have many more examples of schools today that beat the odds than ever before. And no system of schools testifies to that fact more powerfully than KIPP."³

The story will be compelling. The Knowledge is Power Program (KIPP) was founded in 1995 with two schools, and today enrolls over 50,000 students in 141 schools in twenty states and the District of Columbia.⁴ KIPP uses a "no excuses" model of character education, long hours, and a heavy stress on achievement—all techniques that, from the best of what formative studies can tell us, help close the achievement gap and all techniques that would be well-nigh impossible to administer in traditional district schools.⁵ Although 80 percent of KIPP students qualify for free or reduced lunch, 90 percent of students graduate from high school and 80 percent matriculate to college.⁶ Perhaps more material than any of these metrics for success, if you talk to any KIPP administrator he will stress just how long the wait-list for enrollment is; KIPP DC's waitlist, for example, is 2,500 students long.⁷

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But when it comes to KIPP’s waitlist, two things are true. It is certainly true that the waitlist is a vote of confidence, a signal of demand, and a mark of success. But it is also the most significant condemnation of their school model. KIPP a leader in the charter school field in terms of students served, but its numbers are miniscule compared to the total population its leaders so passionately believe is underserved. Rocketship, another academically promising and relatively fast-expanding charter school system, puts the problem into sound perspective. They note: “There are 14,000,000 students in 13,000 failing schools across the country. If the education reform community creates 100 high performing schools per year, it will take 130 years to eliminate the achievement gap.”⁸

Against this backdrop, the progress of the public charter school choice movement—which now serves, in total, 2.2 million students, just under 5 percent of the total student population in America—seems decidedly paltry. It is hard, however, to fault charter management organizations for the pace of their expansion. Even though they have more autonomy than their district-school colleagues, they still operate in a heavily regulated field. And perhaps more importantly, charter school management organizations have little direct incentive to innovate and scale. Good intentions and hard work have taken top-flight CMOs impressively far. But if KIPP were a private company operating in a free marketplace posting the same results, it would have been taken out of business by a competitor long ago who would have emulated their model and expanded to fill the niche so much more rapidly that they would have crowded out the market in entire regions and become the first brand name in “no excuses” schooling.

For-profits have incentives that public entities and nonprofits lack. The focus on the two bottom lines of product and profit give for-profits every incentive to innovate their product, streamline operations to cut costs, and expand to raise revenues. And yet, no chain of urban

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private schools holds even a candle to KIPP's growth and success. In fact, there are very few chains of urban private schools at all! Point this out to a private school choice advocate, and they would correctly argue that they have to compete with a free product, which unfairly skews the market against them. Where there is public assistance for students, programs are restrictive to certain populations or certain areas. But consider this thought experiment. Next year the Supreme Court rules on *Milton Friedman vs. The Status Quo*, and in the majority opinion Anthony Kennedy writes that the 14th amendment clearly says that every penny of education funding, local, state, and federal, must follow the child to any educational venue of their choice. Could we simply expect to be on track to closing the achievement gap within Rocketship's 130 year time horizon?

No, and most simply because founding and expanding high-quality schools is not an easy proposition. It would require quite a bit of money, cadres of dedicated teachers, as well as a considerable amount of legal, lobbying, and managerial prowess. This paper will focus on the question of how the costs of school creation and expansion could be lowered sufficiently for that thought experiment to yield hope rather than despair.

A New Model's Promise, and Pitfalls

A successful private school would have difficulty expanding for the same reasons as successful business would: a lack of capital, a lack of dedicated people, or a lack of vision. Raising the money, training the staff, and putting together the strategy to form a second or a third school may prove quite beyond the bandwidth of an entrepreneurial school leader trying to found and formalize a successful school. Even if the new school could make that bandwidth, the rate of

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expansion would by necessity be slow—certainly too slow for the tastes of ed-reformers hoping to close the achievement gap within our lifetime. But, to take a cue from the business world, these limitations are the very same reasons why a company would choose to expand by franchise: the company lacks capital, lacks a supply of qualified personnel, yet feel the need or desire to expand rapidly.

What exactly is franchising? The Federal Trade Commission (FTC) defines it as follows:

“Franchising is a method of doing business by which the franchisee is granted the right to engage in the business of offering, selling, or distributing goods and services under a marketing plan or system or system prescribed in substantial part by a franchisor.”⁹

To translate FTC-speak into plain English, if you are a franchisor you: (1) Permit someone to use your name; (2) Permit someone to use your system of operations; and (3) Receive an ongoing fee.¹⁰

To become a franchisor, you need to have a prototype business that’s profitable and well-examined for potential weaknesses. Intriguingly – most businesses that start franchising only have one operating unit.¹¹ When it comes to private schooling, a franchising mindset should give great confidence and focus to an aspiring educational entrepreneur. If an education entrepreneur thinks he has a great idea, all he necessarily needs to do is create one functional model.

This entrepreneur wouldn’t necessarily have to simultaneously solicit venture capital, plan building expansions, recruit and train future leaders, become fluent in education law and influential in politics in all of the states and localities in which he or she would wish to operate – all while running an exemplary school – in order to expand. The beauty of franchising is that it

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puts a great deal of the impetus for expansion on the franchisees. Franchisees typically assume the burden of (1) Assuming site-leadership and providing employees; (2) Raising a substantial bit of the capital for launching the franchise; and (3) Using their own local networks to build community buy-in for support and marketing purposes.¹²

When it comes to the first of these three, it's clear that, in education, the condition could be met with ease. No franchise operators have a better chance of success than people who come from a structured big-company environment in the same field. While from-scratch entrepreneurship rewards those who break conventions, write their own rules, and can see with fresh eyes, franchising-entrepreneurship rewards those who are accustomed to following a system, adhering to procedures, and making decisions based on deep familiarity with the nuances of the industry.¹³ There's certainly no shortage of teachers who, due either to the consequences of layoffs or an entrepreneurial itch are looking to teach in an environment over which they have more control and autonomy. If a group of teachers gets inspired by a school—provided that school is interested in franchising—those teachers could visit, learn, and go about planning to launch their own local version of it.

Taking the thought experiment above as a jumping off point, one could imagine a few—and it would only take a few—new schools being founded that could be replicated. Entrepreneurial educators across the country could look to those exemplars, and choose to become a franchisee of a version of Rocketship, or Carpe Diem, or other models yet to be dreamt up. If a school model has proven to work across the first few “innovators”, a larger number of “early adopters” may soon follow suit.¹⁴ All of a sudden in our thought experiment the timeframe for closing the achievement gap looks like it might take fewer than 130 years.

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Coming back to the central issue, two objections to this flight of fancy can readily be made. First, an objector may say “This sounds awful, it sounds like turning schools into fast-food joints.” Second, one might object, “This sounds great, but human resources aside, the other hurdles are too great.” The first objection has, on its face, a strong emotional appeal. Franchising can certainly take the form of “we have a process for creating a product which we just need people to mechanically execute,” a la McDonald’s or Taco Bell. However, if an edu-Ray Kroc were to develop a more efficient and consistent methodology for producing educational proficiency, families and students deserve to have that option on the table regardless of how it strikes the tastes of others.

More importantly, the first objection is based on a limited understanding of the nature of franchising. In addition to taking a set formula and replicating it at scale, franchising can also do two other things. First, it can give skilled practitioners a slightly different method of operation while also giving them a distinct imprimatur of quality. Take Century 21 International for an example. Century 21 started out not as a brokerage firm, but as a proposition. It’s founders, Art Bartlett and Marshall Fischer approached brokers with a deal: “You are going to pay us an ongoing rate... and in turn we will bring you a powerful image and draw sales associates to your office that you could never draw before.”¹⁵ Century 21 did not have an assembly-line or a “secret sauce.” It had some guidelines for its brokers, but more importantly it found quality people in different regions across the country who would be willing to found offices, and let them control the growth of their offices and then their regions while operating under Century 21 brand.¹⁶ Translated to the world of education, one could easily imagine a group of teachers starting out with nothing more than a “tips and tricks” guidebook, and connections to other passionate

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entrepreneurial educators, and growing into a network of teacher-collaboratives with a brand that helps sustain the momentum of quality growth.¹⁷

Second, franchising itself can change the way that business is done. Consider the example of Midas International Corporation. The world-renowned muffler and automotive parts distributor was founded by Nate Sherman, a “Nebraska farmboy” born in 1898. After the depression, Sherman left his Nebraska farm for a Chicago salvage yard, and developed a reputation for salvaging and selling auto-parts. Eventually, he gained the capital to rent a small factory in Hartford to manufacture mufflers for Model Ts. As his company grew, Sherman and his business partners developed the industry’s leading product, but eventually Sherman found that distributors were dictating the terms of his business to him, and resolved to find another way. He resolved to, “go from the point of manufacturer all the way through the point of installation while controlling the distribution channel.” So, he established Midas Muffler Shops, the first retailer in the industry to offer direct marketing and instillation of exhaust systems to the public through franchised specialty shops. Of course, children aren’t mufflers. But that’s not the point of this story – the point is that with a superior product in hand Sherman was able to shake up the landscape of how folks serviced their automobiles. The easy education analogue here would be subject-matter instruction. If a startup has a demonstrably superior methodology of mathematics instruction, it would be harder for them than it was for Sherman to get it distributed through the normal channels. But if those channels could be bypassed by subject-matter franchises, it could shake up the landscape of how folks educate their children.¹⁸

However, the second objection, on the scale of the hurdles that budding franchisors and franchisees would face, is sound. Even if we posit a full marketplace, replicable school models, and a ready supply of high-quality entrepreneurial instructors, two seemingly insurmountable

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problems linger. First, the sheer cost of opening up new schools. *Entrepreneur* magazine's "2014 Franchise 500" lists costs and information of franchise opportunities for prospective entrepreneurs. It would be a challenge and risk for a budding entrepreneur to come up with the \$86,000 for a Subway or the \$297,000 for a Pizza Hut¹⁹. But would be a challenge of another order of magnitude to come up with the \$4,500,000 to start a Primrose School franchise – and Primrose only caters to preschoolers!²⁰ Second, schools take more than money and teachers to grow and operate. They also take administrators, lawyers, managers, and friends in high places.

In theory, both of these problems could be solved by venture capitalists. But before we make the case for how and why venture capital institutions could work hand-in-hand with franchising to lay the groundwork for the explosive growth of high-quality education providers, we must deal with two conditions that any venture capitalist worth his salt would flag as sticking points. First, schools seem to be universally big-box, high capital, high expense operations that have proven impervious to streamlining. And second, that there's no money to be made in investing in schools. To counter the first assumption, we will discuss prospects for efficiency gains in the delivery of K-12 schooling. And to address the second, we will give an overview of a promising development in social finance: social impact bonds.

Efficiency: Technology and Talent

Labor-intensive enterprises become more expensive over time. This phenomenon, known as Baumol's cost disease after the economist William Baumol who first documented it, is seen in numerous industries, including education. Think about getting a haircut. The tools are the same as they were 50 years ago. It takes about the same amount of time, or even less, but just from

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1980 to today, the price of a haircut has increased 8.5 percent in real dollars.²¹ This happens because the cost of living for workers continues to rise, and thus salaries and benefits must rise as well to stay competitive.

Conversely, industries that can replace labor with technology can actually decrease the cost of producing goods and services over time. In that same time frame, the average cost for personal computers have decreased over 80 percent (from \$1,585 in 1980, or \$3,693 in 2010 dollars to \$710 in 2010). This has happened even though the quality has increased exponentially. Why is that? Because most of the production of computers is automated and can be held relatively constant over time. Simply holding all things constant, Baumol's disease drives up the cost of labor-intensive work. But managers and workers can also to accelerate the costs of labor. The woes of Detroit offer a cautionary tale.

The auto industry accelerated the costs of Baumol's disease for over a generation. In 1950, General Motors (GM) signed what has become known as "The Treaty of Detroit" with the United Auto Workers, the union that represented the lion's share of its workforce. In that agreement, to prevent the strikes that had at times crippled production in the decades prior, the automakers agreed to a generous compensation package including vacation guarantees as well as healthcare and pension benefits. In return, the unions gave up some bargaining rights but more importantly agreed to a five-year contract that would ensure stability over the course of the agreement. This set the stage for agreements with Ford and Chrysler and became a blueprint for labor organizers in other fields as they sat down to the bargaining table.²²

Over time, the relationship between management and labor in the auto industry led to untenable promises. As the market share of GM, Ford, and Chrysler shrunk as a result of

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increased competition from Asian manufacturers Honda and Nissan, the company was still burdened with the obligations that it had made to its pensioners. According to a 2007 analysis by *Fortune* magazine GM spent on average \$1,635 per car on healthcare for workers, including retirees. It spent \$630 per vehicle for vacation time and work hour regulations. As demand flagged and production slowed, because of labor agreements even if a plant was shut down, it still had to pay workers 95 percent of their pay as well as their full benefits, or \$1,545 for every car they did not make. This led to an average loss across the company of \$350 per vehicle. Poor quality and poor marketing cost another \$1000 per vehicle, meaning that in 2007, GM actually lost an average of \$1,400 for every car that they made.²³

The quality of GM's cars did not increase at the same rate as their price. This drove consumers to pick other cars, and GM to bankruptcy. GM's experience offers a cautionary tale when talking about the lessons we can derive from their experience. It is not just about labor costs, it is about quality.

Increasing costs in education with stagnant or slowly rising quality has been a documented phenomenon for decades; the overall cost of a K-12 education has increased by almost 200 percent since 1970 while reading and math scores for 17 year-olds have remained mostly flat.²⁴ Labor is the largest single line item in any school. A back of the envelope calculation based on nationwide expenditure data places labor costs at around 75 percent of total expenditure per year.²⁵ Education requires a skilled workforce, and as both the cost of college and the return to a college education have increased, so have labor costs. This makes education more and more expensive every year.

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The acceleration of costs in public education would happen irrespective of labor agreements, but, like Detroit, the American education system has put its foot on the gas of Baumol's disease, in two ways. First, schools have mostly chosen to compensate teachers based on "step-and-lane" pay scales. This structure gives raises to teachers every year based on their years of experience and the advanced degrees that they have earned. These salary bumps cost taxpayers approximately \$15 billion per year.²⁶ Unfortunately, while research gives some credence to increased productivity with increased experience, the effect appears to taper off after the first few years of a teacher's career.²⁷ There appears to be no boost from future post-graduate education.²⁸ Because compensation has been disconnected from productivity, there is enormous slack in the system. As Harvard economist Thomas J. Kane puts it "Paying teachers on the basis of master's degrees is equivalent to paying them based on hair color."²⁹

Second, traditional public school systems have chosen to provide retirement benefits through defined contribution pension plans, often with allowances for "double dipping." Defined contribution plans offer teachers a percentage of their final years' salary as retirement compensation after a certain period of employment. If, for example, the period of time necessary to get one's full pension (which is on average between 60 and 75 percent of final salary) is 30 years, a teacher that begins at age 22 can start collecting these benefits at age 52. This might help explain why the median age for retirement of public school teachers is 58, while the median retirement age for the private sector employees is 62.³⁰ Compounding this cost is the fact that in many locations, pensioners are able to go back to work while still collecting their pension, what is known as "double dipping." Carmen Fariña, Chancellor of the New York City Public Schools is a prominent example of this phenomenon. When she retired after 40 years teaching and working as an administrator, she became entitled to a \$199,579 per year pension. When she was

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picked to be chancellor, a job with a \$212,614 per year salary from the same organization, she did not lose her pension; she is able to collect both. This brings her total compensation to over \$412,000 per year, almost double Mayor Bill De Blasio's \$225,000 per year salary.³¹ Allowing for this behavior drives up costs without a clear gain in productivity.

Insofar as private schools are able to make more fiscally prudent decisions, they will be able to save money. While all of this has been happening in the public sector, private school choice programs have funded students' education at well below the average public school expenditure. Looking at the three largest voucher programs, the Indiana Choice Scholarship Program, the Louisiana Student Scholarships for Educational Excellence Program, and the Milwaukee Parental Choice Program sees average voucher funding of \$4,091, \$5,300, and \$6,442 respectively, when the average funding per pupil per year in America is more than \$10,000.³² This means that they have had to compete for talent with organizations that can offer more generous compensation, and try and deliver a comparable or superior product with less revenue.

In order to compete in this difficult environment as well as keep up with the broader forces that are pushing up costs, schools participating in choice programs need to rethink three facets of their operation to gain a competitive advantage.

Rethinking Compensation

Private schools have the opportunity to compensate teachers based on their effectiveness, not simply their experience. Interestingly, many choose not to. In a survey of 37 Catholic Dioceses by the National Catholic Education Association, all reported some variation of the step-and-lane

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system. In 29 of those dioceses, reaching the top salary lane required an advanced degree, usually either a PhD or a Master's degree plus at least 30 hours of additional credits.³³ Schools that wish to be more efficient and cost effective could establish compensation systems based more on productivity than longevity or increased numbers of degrees.

Rethinking retirement

A comparative advantage, at least when it comes to keeping costs down, that private schools have to public schools is their use of *defined contribution* instead of *defined benefit* pensions. Defined contribution plans, place some percentage of a worker's salary into a tax-advantaged retirement account that he or she can invest and cash out as he or she sees fit. Defined contribution systems are also fairer for younger teachers and short service teachers. Because most systems require teachers to both work for a set amount of time (usually around five years) to get "vested" in the retirement program and to stay in the system in order to maximize accrual, mobile teachers and those who only teach for a short period of time lose much of their retirement benefits.³⁴ In fact, economists Robert Costrell and Michael Podgursky estimated that a teacher in Ohio who entered the profession at age 25 and taught for 15 years before moving to another state would lose over \$500,000 of pension wealth (74 percent of total pension wealth) because of the states pension rules. That same teacher would lose \$407,000 in Missouri, \$200,000 in California, and \$195,000 in Massachusetts.³⁵

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Rethinking Staffing

The way we organize schools today, with age graded classrooms of 25 or so students led by a single teacher progressing through a relatively standardized curriculum is as much an artifact of history as it is of pedagogy. The schools of today were born out of the progressive era wherein large numbers of students were brought in to learn basic skills and socialization and be prepared for the increasing demands of the labor market. As our world has changed, our schools have not.

According to the Digest of Education statistics, the student teacher ratio has fallen from 25 students per teacher in 1960 to only 15 students per teacher today.³⁶ If the ratio of teachers to students does not change, and the cost of the teacher increases, the cost per student will increase.

This can change. One organization offering cost-reducing and quality improving organizational changes is Public Impact, a non-profit research organization led by Bryan and Emily Hassel. They have offered over 20 redesign models that staff schools differently to encourage efficiency.³⁷ One such model is that of elementary school specialization. Under this model, elementary school teachers, like high school teachers do today, specialize in particular subject matter and thereby decrease the breadth of the planning that they need to do for a given day. Students (or teachers) can then rotate between classrooms. Teachers can teach more students more effectively because of their laser-like focus on particular subject matter. Public impact also offers a “pod” model that places a teacher leader at the helm of a relatively autonomous group of teachers within a school.³⁸ They are free to divide up students and plan instruction as they best see fit, organizing their day and their teaching to improve quality and efficiency. Under both of these models, there is less need for support staff and teachers are able to effectively teach more students, driving down the cost of providing education.

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Rethinking Technology

Technology might have the most promise in increasing the efficiency of delivering instruction to students. As Terry Moe and John Chubb outline in their landmark work *Liberating Learning*:

“Once freed from traditional school system rules, public education meshed with technology can innovate very swiftly. Teachers can play new roles, lessons can be presented in creative ways not possible in a traditional classroom... Monies can be poured into instructional design that would other be spent on teacher who now have to design all the courses themselves.”³⁹

This new organization can extend the reach of high-quality teachers and automate some of the rote processes that take up teachers’ time. All of that represents cost-savings as well as increases in the quality of a teacher’s life as more time and energy can be poured into teaching and less into managerial minutiae.

Public Impact again offers several useful models of school organization that leverage technology to take some of the burden off of teachers. One is known as a “hybrid” or “rotation” model that splits a student’s time between computer-driven and teacher-driven instruction.⁴⁰ This model relies on computer software to teach students the basic skills and content that are present in each year’s curriculum, and leverages the teacher for discussion, in-depth analysis, and extension of the content and skills that students learn. It also allows students to progress at their own rate, so classroom management, which often is pre-occupied with students who are ahead or behind the rest of the class, becomes much easier. Much like specialization in the elementary grades, this model takes much of the burden off teachers and allows them to both focus on what they do best as well as effectively reach more students.

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Hybrid models, though, tend to take the school day and year as given. *Remote* models remove all of those assumptions. Rather than having students or teachers come to a particular school building, remote instruction leverages online platforms, video conferencing, and chat features to deliver instruction.⁴¹ This allows teachers to extend their reach to students all over the district, state, or even planet and automates many processes that take up teacher time and energy. Teachers can work from home, or from worksites with shared space for collaboration. By removing the need for brick and mortar buildings, the cost of providing an education drops dramatically.

Funding With Social Impact Bonds: It's All About Risk

Even the leanest school design still needs funding to get off the ground. While there is a time worn process for funding for-profit ventures in technology, manufacturing, and service industries funding social programs is a bit trickier. New schools require taking a chance on an organization in the hopes that it will be able to fix a problem that tax dollars have been levied to solve. Traditionally, government has assumed all of this risk. They front the money, they evaluate the program, and then they make a determination if their continued investment is worthwhile. If, after examination, the program is not working, all of the money that has been spent to that point has been, put plainly, a waste.

This makes public management a difficult and fraught process. Public spending watchdogs love to use a failing program as evidence that the government is dysfunctional and argue for decreased investment in that particular sector. Public spending advocates see myriad problems that government should be solving and use that as evidence that the government is

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dysfunctional and unable to meet the needs of the polity. It can be damned if you do, damned if you don't.

One promising development for getting around this vexing problem is the social impact bond. Social impact bonds leverage a public-private partnership wherein a private finance company, rather than the government, fronts the money for a program and is financially rewarded by the government only if the program is successful.

Started in Peterborough Prison in England in 2010, social impact bonds initially funded programs to decreased recidivism in prison inmates.⁴² Recidivism is an extremely expensive problem—it is expensive to keep people in jail. As a result numerous non-profits as well as prisons themselves have developed programs to try and rehabilitate prisoners and help them be successful in the outside world so they do not end up back after failing to re-integrate into society. Unfortunately, most of these programs are unsuccessful.

A non-profit named One Service approached the prison with a rehabilitation program that provided pre- and post-release and mentoring and connection to outside service providers approached the prison with their plan to work with inmates, but rather than ask the prison for funding, they offered a novel proposition. They agreed to raise capital from “social investors” and came into an agreement with the Ministry of Justice that the investors would be repaid, plus performance bonuses, if the program was successful. Much like purchasing land or investing in a business, investing in this program represented an up-front cost that could be more than paid back in the future, that is, it could actually turn a profit.

The program began in September of 2010 with a cohort of 1,000 “short sentence” prisoners (prisoners with a sentence of less than 12 months). The Ministry of Justice agreed to

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pay the investors a fixed amount per inmate if the reduction in recidivism rates was 10 percent less than for a similar cohort of prisoners matched at baseline. To collect and analyze the data, a research team from research firm QinetiQ and the University of Leicester collected reports of reconviction through the Police National Computer and compare them to reconvictions for the matched comparison group. Payment was determined by an outside assessor.⁴³

The project, and its evaluation, is still going on, but interim numbers paint a promising picture. Figures released by the Ministry of Justice in the summer of 2013 show a 6 percentage point decrease in frequency of recidivism, from 87 percent from 2008 to 2010 to 81 percent from 2010 to 2012. Nationwide, British recidivism rates actually increased during the latter time period, with a gain from 69 percent to 79 percent from 2010 to 2012. At least at first blush, the program appears to be working.⁴⁴

Social impact bonds are designed to solve a very particular problem—governments at all levels and all over the world have provided startup costs and initial funding for programs that have not ended up working out. In a world of limited resources, and particularly in tight financial times, the government cannot simply let a thousand flowers bloom and fund all of them. They need to be more strategic. The problem is that government bureaucrats aren't always in the best position to determine what will or will not work, they can be inundated with proposals for funding, not have the expertise necessary to understand the organization or the program, or be captured by political interests.

Investment, fundamentally, is about assuming risk. Investors provide capital to an organization now with the hopes that it will be used productively to make more money, of which the investors will receive some chunk in the future as compensation for giving it in the first

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place. All social impact bonds do is move the risk from investing in social programs the public to the private sector. Rather than petitioning the government to fund a particular intervention, the program's operators would reach out to a bank or financial services company to provide the initial capital. That private firm then enters into a contract with the government to get a piece of the future savings the program.

So how would this work in schools? The key would be to indentify particular indicators associated with increased government spending that increased quality education decreases, monetize them, and track how programs affect them.

For a concrete example, economists Lance Lochner and Enrico Moretti have estimated the effect of increased education on crime.⁴⁵ Crime, as they demonstrate, is extremely costly. Theft, robbery, arson, assault, rape, murder all represent enormous costs for victims as well as a criminal justice system that needs to investigate, try, and punish offenders. Luckily, they find that increased education decreased the significantly reduces the likelihood of incarceration. In fact, they find that the difference in educational attainment (high school and college completion) explain 23 percent of the gap between black and white men's incarceration rates. Doing the math, the authors estimate that each additional high school graduate is worth on average \$28,000 to society in the decreased cost of crime.

Other economists have tracked increased earnings (and thus increased tax payment), decreased likelihood of ending up on welfare, and improved life expectancy and long-term health, all associated with high school graduation and totaling the value, society and the individual of almost half a million dollars for a high school diploma.⁴⁶

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Unfortunately, dropout figures across the country are disheartening. In the District of Columbia Education Week's Diplomas Count reported only 57 percent of the class of 2010 graduating. In Mississippi it was 64.4%. And that is for all students in a state, when looked at independently African-Americans in many states fair extremely poorly with only 58.9 percent of Arizona African-American students in the class of 2010 graduating, 45.5 percent in Nevada, 48.4 percent in North Carolina, and 52.3 percent in Wisconsin.⁴⁷

Imagine if investors could provide the startup capital for a school with the promise of financial return for every projected dropout that did not, in fact, drop out. Payment could be structured such that if the school graduates students at the same rate as demographically similar schools they simply receive the funding that would normally be allocated to them. If they beat projections, they (or more specifically their investors) would get a bonus. If they did not meet projections, they would only be paid some fraction of the normal allotment, that is, investors would take a loss.

Now, it should be noted that this is not a vision for financing every school in America. This is designed for newer models that want to try something new or different, but the government might be reluctant to fund. It's a public private partnership that insulates the government from being on the hook for a failed experiment.

Venturing into Franchise

So an organization might be lean and mean, and have the capital to start, but that does not mean it will be effective in education students. Edison Learning offers a cautionary tale. Initially, the goal of Edison schools was to be more efficient than district schools. If they received the same

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amount of money but streamlined operation, the difference was profit. It didn't work out that way. Founded in 1991 by Chris Whittle with the goal of opening 1,000 for-profit schools in five years, Edison Learning (at that time Edison Schools) lost \$112 million by 1999, and even after an initial public offering that raised another \$173 million in capital, the company's stock lost 98 percent of its value by 2002. By 2005, the company managed only 157 schools.⁴⁸ Today, it still manages schools, but focuses mostly on providing school management, virtual, and alternative education services.⁴⁹ According to researchers from the National Education Policy Center, there are only 385,000 students across the country in schools run by for-profit education management organizations.⁵⁰ One would assume if it was lucrative business, profit-seekers should have been able to take a bigger chunk.

While the profit motive has many positive attributes that drive scale and efficiency, there are serious downside risks to having for-profit organizations operate schools. Simply trying to lower costs of instruction below what the state gives in per pupil allotment has implications for adverse selection, cream-skimming, and corner cutting. In short, under a traditional funding scheme, as long as you keep bodies in the school, you get paid. If the amount of funding is constant, schools have the incentive to find the least expensive students to educate and do whatever is minimally necessary to keep them in the school. That is not to say that all would, but without variable funding weighted based on student need or legal compulsion to serve a more diverse student body, it is not unreasonable to expect these problems in profit-oriented schools. This is why, ultimately, we have little confidence that "for profit" schools, in the traditional definition, hold much promise for improving education.

We offer a more nuanced proposition. Our vision, of individual schools (which are not themselves trying to make a profit) financed by those with a profit motive, attempts to get the

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best of both worlds. This happens because social impact bonds place an additional layer of responsibility. Yes, a school operator needs to keep bodies in the school, but they also have to serve them or risk losing investors' money. The money comes in hitting the performance targets, not in simply keeping students around. Given the fact that these targets, like those related to recidivism, can be sensitive to different student demographics, they can get around some of the adverse selection issues that lump-sum funding creates. They also protect taxpayers from risk in funding new and different ventures. Taxpayers only have to pay if the program works. This helps blunt criticisms that tax dollars are flowing into “unproven” or “untested” school models, but there still needs to be more to help midwife new schools into existence.

Andy Smarick, in his paper in this collection, describes lessons that a budding private school choice sector could take from the charter sector. He pointed out how crucial satellite support organizations have been to the expansion of successful charter schools. Successful charter schools have had incubators which were explicitly “dedicated to intentionally building the supply of high quality charter schools and CMOs in cities or specific geographic areas.”⁵¹ These incubators helped provide startup capital to educators who aspired to found schools or school leaders looking to expand their school system. They helped develop leadership and talent pipelines, serving as a central hub to connect those trying to expand a charter school system with those hoping to be a part of an expanding charter network. They provide ongoing strategic support to the overall development process and political advocacy when their affiliated schools run into difficulties.⁵²

Even if *Milton Friedman vs. The Status Quo* were decided tomorrow, it's far from clear whether any analogous organizations would develop to incubate and help expand private choice schools. The organizations Smarick describes have been funded in part by government grants,

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and in part by private philanthropy. Even if the legal climate were to change, it's hard to imagine politicians providing the magnitude of grants to private school satellite organizations that they had provided to public charter school support organizations. First, there is a sound case from both liberals, concerned about the effects of profit-seeking on education, and conservatives, worried about crony capitalism, against the government funding for-profit school organizations. And aside from politics, the poorly aligned profit incentives of organizations like Edison Learning make it a tough policy sell for even a "disinterested" government grant facilitator. And although there is less than a clear marker for this, it seems plausible that private philanthropists may also share that predilection towards funding non-profits in the education sphere.

So, the realization of a private sector analogue to the institutions that have fostered the charter movement's successes seems a dim prospect. That is, unless lawmakers pass provisions for social impact bonds. Those bonds would be a game changer, and a sine qua non to a fully functional school choice "market" and the rapid scaling of successful school franchises.

Social impact bonds would provide the financial vehicle for the establishment of private school choice venture capital firms. What exactly is a venture capital firm, and what would it look like to have one in the private-school choice space? A venture capital firm is a financial intermediary that takes investors' capital and invests it directly in private, non-publicly traded, portfolio companies. A venture capital firm then takes an active role in monitoring and helping the companies in its portfolio grow, and often makes follow up investments to help fuel its portfolio companies' growth. Ultimately, a venture capital firm intends to profit through an "exit" either by selling its share in the company or through that company's initial public offering.⁵³

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Venture capitalists typically look for their “exit” to result in an effective annual compounded rate of return of 25 percent. Given the experience of Edison, it’s difficult to imagine private school management organizations presenting investors with such an opportunity while still keeping incentives well in line to properly serve their students. But given the advent of social impact bonds and the concomitant realignment of incentives and larger pool of prospective investors, it’s easy to imagine social entrepreneurs seizing the opportunity to found such a firm.

Venture capital firms, in general, operate not with their own capital but with capital from individual and institutional investors. While it’s doubtful that a portfolio of private school choice education providers would ever present the prospect of the rate of return that conventional venture capitalists look for, the prospect of doing well by doing good should be able to attract significant capital. Philanthropic foundations may see in a firm an opportunity to engage in philanthropy without drawing down on their capital reserves, large investors—such as mutual funds brokers—may determine that the lower rate of return is outweighed by the public image yielded by the investment, and individuals may also sacrifice a marginal percentage on their rate of return to take part in the social mission.

Given the capital, there is every reason to expect that venture capital firms could provide the analogue to the public charter support organizations, and then some. Just as the human capital from which franchises could be formed already exists in our nation’s teacher workforce, the decades of infrastructure building in the charter sector has trained a generation of leaders with the skills, knowledge, and drive to staff and operate venture capitalist firms. In many ways, these venture capitalists would be mirror images of organizations like The Mind Trust and New Schools for New Orleans.⁵⁴ But there would be three crucial differences. First, the freedom to operate within these venture capital firms would be greater, both in their internal operations due

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an emphasized financial reliance on individual bond purchasers over non-profit or public entities which often attach a plethora of strings to any money. Second, the nature of the portfolio schools these venture capitalists could hold should prove more diverse and innovative. For all of the promise of autonomy that charter schools offered, they frequently look functionally indistinguishable from district schools. Because of the drive towards efficiency and innovation in for-profit organizations, private school choice schools and franchises will have greater structural incentive to keep the costs down and the results up. Third, if and when a portfolio company lands upon a successful school model, the venture capitalist will have every incentive to help that model expand. That incentive will not just come from the good-hearted nature and passion of its employees, but because its investors will demand it if the social impact bond incentives are properly aligned.

Between founders, venture capitalists, and franchisers, it becomes much easier to imagine an educational ecosystem that is bounding towards closing the achievement gap in far fewer than 130 years. Imagine a group of committed teachers in Columbus, Ohio band together around an innovative blended-learning school structure. If a group of educators in Hot Springs, Arkansas learns about a new school in Columbus, they could look further into it to examine whether it might be an endeavor they'd like to be a part of. If venture capitalists in Chicago have also taken an interest and placed that school within their portfolio, the Arkansan teachers could pitch becoming a franchisor to those venture capitalists. Back in Hot Springs, those teachers could begin to go about the work of setting up shop and getting the word out about their school model, while the Chicago venture capitalists help both by offering their own advice and providing their own capital, as well as by working alongside those teachers to secure social impact bond investors in their own community. With those investors comes literal community buy-in, folks of

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means and influence who now have an active interest in making sure that this new school takes root and thrives. Two years later, a teacher from St. Louis is visiting her retired mother in Hot Springs and she learns about this new school that the folks are buzzing about. Within fifteen years, what began with a group of teachers in Ohio has become a school-model as ubiquitous as Chipotle.

It sounds like a flight of fancy, and for the time being it surely is. But this is exactly the type of competitive disruption that Milton Friedman had in mind when he wrote the paper that sowed the seeds for the school choice movement. This is also quite probably the only theory of action that could plausibly give a chance at a good education to the 14 million students in failing schools on a time horizon shorter than a century. Unfortunately, choice advocates these days all too often debating whether choice “works” and how choice can be “expanded.” But an innovative educational ecosystem cannot live on choice alone. Parents having a “choice” of where to send their children to school is a necessary but not sufficient condition for systemic reform. For systemic reform to occur, a market-condition must hold, and there must be a coherent theory of action for market-actors, and there must be institutions sufficient to support those actors. This paper serves as an attempt to put forth such a theory, based on franchise expansion, supported by private school venture capital undergirded by social impact bonds.

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