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## For-Profit and Nonprofit Charter Schools: An Agency Costs Approach

**ABSTRACT.** This Note applies agency costs theory to explain charter schools' use of for-profit and nonprofit forms, and to suggest ways to make charter school regulation more sensitive to the differences between these forms. Borrowing from Henry Hansmann's "contract failure" theory of nonprofits and recent data on the makeup of the charter school market, I argue that nonprofit forms dominate because they minimize the unusually high agency costs that characterize interactions between charter operators and the parents, regulators, and donors who influence them. For-profit schools survive only when the economies of scale they capture through superior capital-raising offset their higher agency costs. I also compare nonprofits' and for-profits' abilities to achieve some of charter school policy's more complex goals. These include resource attraction, localized governance, and output-based accountability. I conclude by arguing for changes in regulation to control for-profits more tightly and to reflect more accurately nonprofits' and for-profits' relative strengths.

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## INTRODUCTION

Charter schools are becoming an increasingly important part of America's primary and secondary education system. Since 1991, forty states, the District of Columbia, and Puerto Rico have authorized charter schools,<sup>1</sup> and more than 3000 such schools have opened.<sup>2</sup> Congress has recently devoted considerable time and attention to charter schools, authorizing major grant programs to assist charter schools with startup costs<sup>3</sup> and facility acquisition,<sup>4</sup> and allowing failing conventional public schools to restructure themselves as charter schools under the No Child Left Behind Act.<sup>5</sup>

As charter schools increase in importance, so does the debate about the laws that govern them. In this Note, I examine one aspect of that debate: whether to organize charter schools as nonprofit or for-profit entities. The role of profit has become a contentious issue in charter school policy. For-profit schools have drawn criticism for cutting quality in the interests of shareholders and overlooking the public good aspects of education. They have also drawn praise, however, for the innovation, efficiency, and market-style discipline they promise to bring to education.

I explore charter schools' use of the nonprofit and for-profit forms from the perspective of agency costs theory. Though the debate about charter schools is so broad that strong claims about its content are dangerous, voices well informed by agency costs theory appear to have been largely absent. This Note seeks to fill that gap.

Agency costs theory illuminates the debate about charter school organizational form in a number of ways. First, agency costs theory explains the relative dominance of nonprofits in the charter school market. As Henry Hansmann has argued, the nonprofit form is useful when principals have an unusually difficult time monitoring or enforcing contracts with their agents. By prohibiting nonprofits from distributing earnings to shareholders, state laws allow nonprofits to pledge with a high degree of credibility that they won't cheat their patrons in ways the patrons can't perceive or control. Since nonprofits don't stand to gain anything from cheating, they have little reason to do it. Hansmann's model fits the charter school market, because the various

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1. US Charter Schools, State Information, [http://www.uscharterschools.org/pub/uscs\\_docs/sp/index.htm](http://www.uscharterschools.org/pub/uscs_docs/sp/index.htm) (last visited Feb. 28, 2006).

2. See *infra* tbl.1.

3. 20 U.S.C.A. §§ 7221-7221j (West 2003).

4. *Id.* §§ 7223-7223j.

5. *Id.* § 6316(b)(8)(A)-(B)(i).

parties that control charter schools' success—parents, government agencies, and donors—all have a great deal of difficulty perceiving and controlling abuse and cheating by charter schools. In other words, monitoring costs are high and the nonprofit form reduces them. A significant minority of for-profit charter schools exists in spite of these high monitoring costs, however, because for-profit schools' superior access to capital markets allows them to operate on a large scale. For-profit schools exist when they can achieve economies of scale that outweigh agency-cost inefficiencies.

Second, agency costs theory suggests that nonprofits may be better than for-profits at furthering some of charter school policy's more complicated goals. Nonprofit schools attract charitable donations and improve local teachers' and parents' control more effectively than for-profits do. This conclusion must not be overstated; for-profit schools may be slightly more responsive to the pressures of output-based accountability than nonprofits are. But there is little doubt that organizational form has important consequences for charter schools' abilities to actualize the goals of charter policy.

Finally, agency costs theory suggests that regulators may need to control for-profit schools more aggressively than nonprofit schools. The rhetoric of the charter school movement has emphasized charter-school-specific forms of accountability, such as parental monitoring and periodic output-based review by government agencies. But agency costs theory suggests that the nonprofit form may be just as important in regulating most charter schools as these more direct forms of accountability are. For-profit schools not subject to the nonprofit form's constraints are therefore likely to expose the gaps and cracks in charter-school-specific regulation. In this Note, I suggest a handful of regulatory changes to meet the challenges for-profit schools pose. These include curtailing "hybrid" for-profit-nonprofit management arrangements, limiting for-profit schools' ability to cut quality in imperceptible ways, and strengthening existing governmental monitoring and information-gathering systems.

I begin in Part I by explaining the charter school concept and the organizational forms charter schools use. These forms tend to be complex and cannot be placed into "nonprofit" and "for-profit" categories as neatly as forms in most industries. In Part II, I explain nonprofit schools' relative dominance. In Part III, I explain why nonprofits' dominance is not total, and why there are still a significant number of for-profit charter schools. I move in Part IV to examining how for-profit and nonprofit schools differ in achieving some of the more complicated goals of charter school policy. In Part V I then propose changes in regulation to meet the challenges posed by for-profit schools.

## I. CHARTER SCHOOL STRUCTURE

“Charter schools” are notoriously hard to define. Charter laws differ widely from state to state, and charter schools exist alongside other school choice regimes, some of which go by different names but are difficult to distinguish from charter schools.<sup>6</sup> The concepts of “for-profit” and “nonprofit” are also complicated in the charter school context. Mostly to avoid restrictions on for-profit entities’ abilities to hold charters directly, charter schools have produced unusual fusions of for-profit and nonprofit legal forms that defy easy categorization. To clarify these murky concepts, in Section A I define “charter schools” and distinguish them from conventional public and private schools. In Section B, I draw distinctions among charter schools, and separate these schools into for-profit and nonprofit groups.

### A. *The Charter School Concept*

Charter schools combine elements of conventional public and private schools.<sup>7</sup> The key characteristic of a charter school is that it combines public funding with private management. Unlike conventional private schools, charter schools do not charge tuition<sup>8</sup> and receive all of their funding from state and local governments, school districts, and private charitable donations. Unlike conventional public schools, however, charter school teachers and managers usually are not government employees.<sup>9</sup> State laws place few

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6. Like charter programs, voucher programs combine public funding and unsolicited private operation. The main difference is that vouchers are more lightly regulated: Voucher schools often do not have to pass a review process to open, and are not subject to closure or persistent state monitoring. See MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 89 (Univ. Chi. Press 1982) (1962) (comparing voucher regulation to restaurant sanitation inspections). John Chubb and Terry Moe, two early and highly influential school choice advocates, for example, used the term “chartered” to describe the schools in their proposal, even though their proposal looks more like a modern voucher program than a charter program. JOHN E. CHUBB & TERRY M. MOE, *POLITICS, MARKETS AND AMERICA’S SCHOOLS* 219 (1990).
  7. The definition I offer in this Section combines observations about state laws, which enable and directly regulate charter schools, with the formal definition of a “charter school” established by Congress for determining federal startup grant eligibility under the Public Charter Schools Program, 20 U.S.C.A. § 7221i(1) (West 2003); U.S. DEP’T EDUC., *CHARTER SCHOOLS PROGRAM: NONREGULATORY GUIDANCE, TITLE V, PART B*, at 6-7 (2004).
  8. 20 U.S.C.A. § 7221i(1)(F) (West 2003).
  9. See *id.* § 7221i(1)(B), (2). Under the federal definition, charter schools can, however, be operated by public entities. *Id.* § 7221i(2). When public entities operate charter schools, they are often separate from conventional public school districts. Of course, the line between publicly operated charter schools and conventional public schools is quite thin.

restrictions on who can start a charter school, and the charter school definition the U.S. Department of Education uses for administrative purposes allows parents, teachers, school administrators, and any “members of the local community” to operate a charter school.<sup>10</sup>

Enrollment in a charter school is also usually optional.<sup>11</sup> Unlike conventional public schools, charter schools rarely have geographic boundaries inside which attendance is compulsory.<sup>12</sup> Students can leave charter schools for other charters, conventional private schools, or conventional public schools. If a school has more students wishing to attend than seats, it must admit students by lottery.<sup>13</sup>

Prior to opening, a charter school must receive a “charter” from a statutorily authorized agency.<sup>14</sup> Under the federal definition, any “public entity” authorized under state law and approved by the Secretary of Education can authorize a charter school.<sup>15</sup> In most states, charters may be granted by local districts, state departments of education, or universities. The chartering process and the level of scrutiny applied to charter applications vary widely among states.

A related point is that chartering agencies rarely solicit applications. Unlike most publicly funded, privately operated enterprises, charter schools typically apply for public funding on their own initiative, operate largely according to their own terms, and rarely have to endure a competitive bidding process.<sup>16</sup>

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10. *Id.* § 7221i(2).

11. *Id.* § 7221i(1)(H).

12. Some school choice plans allow choice among conventional public schools. *See, e.g.*, CHUBB & MOE, *supra* note 6, at 206-15; Chester E. Finn, Jr. & Rebecca L. Gau, *New Ways of Education*, 130 PUB. INTEREST 79, 86 (1998) (observing that “[t]wenty states now allow some form of inter-district open enrollment”); James E. Ryan & Michael Heise, *The Political Economy of School Choice*, 111 YALE L.J. 2043, 2046 (2002) (“Most public school choice plans are *intradistrict*, meaning that students can choose schools within a particular district but cannot cross district lines.”).

13. 20 U.S.C.A. § 7221i(1)(H) (West 2003).

14. *Id.* §§ 7221i(3)-(4).

15. *Id.* § 7221(4).

16. By capping the number of charter schools at artificially low levels, some states may create a system functionally similar to a competitive bidding process. New York’s charter law, for example, only allows the state’s Board of Regents to authorize fifty charter schools. Elissa Gootman, *In Last Call, Regents Approve 4 New Charter Schools for the City*, N.Y. TIMES, Jan. 10, 2006, at B6. The Board considered six applications in handing out its last four charters under the law. Although a spokesman for the New York City Schools Chancellor said all six applications were “worthy” of charters, only four could win. *Id.* In essence, the six applicants had to compete directly for four charters. The charter application process generally only becomes directly competitive near the top end of a cap, however, and often the caps

When cities hire private trash collectors, for example, they usually begin by defining the areas to be served and seeking competitive bids.<sup>17</sup> In most cases, after signing a contract, the city stops collecting the trash and lets the winner of the bidding process take over. In contrast, school-chartering agencies tend to wait passively for charter operators to come to them, and the goals of charter schools may have little or no connection to the strategic plans of the districts in which they operate. Charter applicants usually determine their own “educational objectives” and basic curricula; these objectives and curricula are merely “agreed to” by chartering agencies.<sup>18</sup> And charter authorizers usually grant charters to worthy applicants even when existing conventional public schools have the capacity to educate all students in an area. This often means that conventional schools’ costs remain the same even after charter schools appear in their areas and begin drawing away students and the funding attached to them.<sup>19</sup> Sometimes charter schools follow a more traditional privatization model. Under the No Child Left Behind Act, for example, local districts, on their own initiative, can dissolve failing conventional public schools and convert them to or replace them with charter schools.<sup>20</sup>

Under the U.S. Department of Education definition, charter schools are “exempt from significant State or local rules that inhibit the flexible operation and management of public schools.”<sup>21</sup> Granting charter schools greater freedom ideally enhances their ability to innovate and operate efficiently. Unlike conventional public schools, which the government monitors by dictating inputs—e.g., whom to hire, what to teach, and where to teach it—charter schools in theory are primarily regulated by the monitoring of their output as measured by student achievement. They develop their own educational objectives and the means for measuring them,<sup>22</sup> and government agencies do not interfere with these decisions as long as charter schools

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themselves come under fire when they prevent charter authorizers from granting charters to worthy applicants. *See, e.g.,* Elissa Gootman, *Lines Are Drawn in Fight To Add Charter Schools*, N.Y. TIMES, Jan. 9, 2006, at A1.

17. For an excellent introduction to the forms and purposes of “contracting out,” see JOHN D. DONAHUE, *THE PRIVATIZATION DECISION* (1989).
18. 20 U.S.C.A. § 7221i(1)(C) (West 2003).
19. *See, e.g.,* UTAH FOUND., REPORT NO. 660, *CHARTER SCHOOLS: CAN THEY SURVIVE IN UTAH?* 17-19 (2003).
20. 20 U.S.C.A. § 6316(b)(8)(A)-(B) (West 2003); U.S. Dep’t of Educ., *Stronger Accountability: Questions and Answers on No Child Left Behind, What if a School Does Not Improve?*, <http://www.ed.gov/nclb/accountability/schools/accountability.html#5> (last visited Jan. 23, 2006).
21. 20 U.S.C.A. 7221i(1)(A) (West 2003).
22. *See id.* § 7221i(1)(L).

demonstrate success. When charter schools fail, chartering agencies or state boards of education theoretically respond by closing the schools rather than by dictating inputs.<sup>23</sup>

The “output-based regulation” ideal has frequently faltered in practice. Charters have often failed to establish meaningful and measurable goals, and charter schools’ freedom is limited by significant input-based regulation. Many (perhaps most) charter schools must comply with state-level regulation of curriculum and teacher qualifications. And exemptions from state laws and regulations appear to have been rare.<sup>24</sup> Charter schools must also be nonsectarian,<sup>25</sup> and must comply with antidiscrimination,<sup>26</sup> auditing,<sup>27</sup> safety and health,<sup>28</sup> and other applicable state<sup>29</sup> and federal laws. Nevertheless, charter schools have often found ways to carve out room for unique curricula and governance structures even in the face of heavy regulation.

### *B. Distinguishing For-Profit and Nonprofit Charter Schools*

Charter school operators have discovered a variety of innovative ways to combine for-profit and nonprofit forms. These forms occupy a continuum, with schools owned and operated by for-profit entities on one end and schools owned and operated by nonprofit entities on the other. Although the charter school literature has often failed to distinguish among these forms, a thorough understanding of them is essential for my purposes. The place a school occupies on the continuum will determine how accurately economic models developed to describe more pure for-profit and nonprofit firms apply.

On the nonprofit end of the continuum are charter schools organized under state laws as nonprofit corporations that qualify for tax exemptions under

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23. The No Child Left Behind (NCLB) Act is bringing charter and conventional public school monitoring regimes closer together. Under NCLB, governments are supposed to respond to persistent failure in conventional public schools by restructuring the schools. 20 U.S.C.A. § 6316(b)(8) (West 2003). The NCLB system differs from charter regimes in important ways, however. First, unlike a failing charter school, a persistently failing conventional public school is not gone forever under NCLB. It must merely be restructured with different employees or as a charter school. Second, NCLB makes no pretenses about giving schools greater freedom in exchange for output-based accountability.

24. See *infra* note 84.

25. 20 U.S.C.A. § 7221i(1)(E) (West 2003).

26. *Id.* § 7221i(1)(G).

27. *Id.* § 7221i(1)(I).

28. *Id.* § 7221i(1)(J).

29. *Id.* § 7221i(1)(K).



I.R.C. § 501(c)(3). In a pure nonprofit charter school, the nonprofit entity that holds the school's charter manages all strategic and day-to-day operations and directly employs all the teachers, administrators, and staff.<sup>30</sup> Also near this end of the continuum are nonprofit charter-holding organizations that hire nonprofit management entities to operate their schools.<sup>31</sup> In these schools, one nonprofit entity may receive the charter from a chartering agency, and then hire a separate organization to actually manage the school. On the for-profit end of the continuum are firms organized as for-profit business entities under state law that both hold charters and manage their schools' operations. Charter schools on the extreme for-profit end of the continuum are rare.<sup>32</sup>

The middle of the continuum is inhabited by what I will call "hybrid schools." In a hybrid school, a nonprofit entity receives and holds the school's charter, and contracts with a for-profit firm for management services.<sup>33</sup> Sometimes these arrangements make genuine economic sense, with nonprofit charter-holding entities and for-profit management firms each playing their roles more efficiently than the other could. Often, though, these arrangements owe their existence to state laws that prohibit for-profit entities from holding charters directly. Since they can't hold charters themselves, for-profit entities find or create nonprofits capable of doing it for them. Nationally, approximately fourteen<sup>34</sup> to nineteen<sup>35</sup> percent of nonprofit charter schools contract with for-profit management firms for at least some services.

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30. Also on this end of the continuum are charter schools that are legally part of the school districts in which they operate. These arrangements appear to be rare. See, e.g., Sandra Vergari, *The Regulatory Styles of Statewide Charter School Authorizers: Arizona, Massachusetts, and Michigan*, 36 EDUC. ADMIN. Q. 730, 736 tbl.2 (2000).

31. See POLICY & PROGRAM STUDIES SERV., U.S. DEP'T EDUC., EVALUATION OF THE PUBLIC CHARTER SCHOOLS PROGRAM 32-33 (2004) [hereinafter PCSP EVALUATION].

32. *Charter School Laws and Partnerships: Expanding Opportunities and Resources* 4 tbl.3 (Educ. Comm'n of the States, Policy Brief, Apr. 2004), <http://www.ecs.org/clearinghouse/51/12/5112.doc>; see also Alex Molnar, *For-Profit K-12 Education: Through the Glass Darkly* (Nov. 14, 2005) (unpublished manuscript), available at [http://www.aei.org/docLib/20051114\\_Molnar.pdf](http://www.aei.org/docLib/20051114_Molnar.pdf) (arguing that for-profit firms rarely directly own either charter schools or conventional private schools).

33. At least six states have prohibited contractual partnerships for school operation between charter schools and for-profit management companies. Educ. Comm'n of the States, *supra* note 32, at 4 tbl.3. Many states that allow partnerships undoubtedly did not intend partnerships to become a means of circumventing restrictions on the direct granting of charters to for-profit schools. See, e.g., Kent Fischer, *Public School Inc.*, ST. PETERSBURG TIMES ONLINE, Sept. 15, 2002, [http://www.sptimes.com/2002/09/15/news\\_pf/State/Public\\_School\\_Inc.shtml](http://www.sptimes.com/2002/09/15/news_pf/State/Public_School_Inc.shtml) (observing Florida lawmakers' surprise at the use of for-profit management companies to circumvent the state's prohibition on direct charter grants to for-profit corporations).

34. See *infra* tbl.1.

The place a particular hybrid school occupies on the for-profit-nonprofit continuum depends on the kinds of services the for-profit management firm provides. Some hybrid schools hire for-profit firms only for limited logistical services or the outlines of a curriculum, and thus fall close to the nonprofit end of the continuum. Most hybrid schools, however, grant for-profit management companies more substantial roles. The U.S. Department of Education found that seventy-one percent of hybrid schools hired for-profit firms to “manag[e] the overall operation or administration of [the] school.”<sup>36</sup> Sixty-four percent had the for-profit firms direct curriculum and instruction, and sixty percent had the firms hire staff.<sup>37</sup> Sixty-four percent of the nonprofit charter-holding entities in hybrid schools also received seed or startup funds from their for-profit managers.<sup>38</sup>

More detailed observation supports the story these national statistics tell of deep involvement by for-profit firms. A report issued by Western Michigan University found that for-profit management companies in Michigan—a state with an unusually high percentage of for-profit schools<sup>39</sup>—often own charter schools’ buildings, equipment, and supplies; nominate and cultivate support for board members of the nonprofit entities that apply for charters; and contribute startup capital.<sup>40</sup> In fact, some management companies in Michigan refuse to contract for anything other than “full service” agreements that grant them total authority over the schools.<sup>41</sup> The existence of a number of for-profit management companies serving only one school<sup>42</sup> suggests that the line between nonprofit charter-holding entities and their for-profit management companies is thin. A for-profit management firm serving only one school would have no economies of scale to justify independence from its client, absent legal restrictions on direct ownership by the management firm.

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35. PCSP EVALUATION, *supra* note 31, at 32.

36. *Id.* at 34 exhibit 3-14.

37. *Id.*

38. *Id.*

39. JERRY HORN & GARY MIRON, THE EVALUATION CTR., W. MICH. UNIV., AN EVALUATION OF THE MICHIGAN CHARTER SCHOOL INITIATIVE: PERFORMANCE, ACCOUNTABILITY, AND IMPACT (2000). Seventy-two percent of charter schools in Michigan have some contractual relationship with a for-profit firm. *Id.* at 43.

40. *Id.* at 47-49.

41. *See id.* at 47.

42. *Id.* at 45 tbl.4:1.

Anecdotal evidence suggests that many nonprofit entities are merely fronts for for-profit firms.<sup>43</sup>

The place a hybrid school occupies on the continuum may also be influenced by the way its management firm is compensated. Two basic arrangements are possible. A management company may receive a fixed fee (calculated per student, per school, or by some other method), and the nonprofit hiring organization may pay all of the school's operating expenses. Under this kind of arrangement, a for-profit firm might have relatively little to gain from cutting costs or quality, except to the extent that overspending might make the nonprofit charter-holding organization insolvent and eliminate the possibility of a continuing relationship. A second possible arrangement may grant a management company a fee and require the company to pay its operating expenses out of that fee. In these circumstances, the for-profit management company has much to gain by cutting costs, since it receives all of whatever surplus remains after expenses are paid. In this kind of compensation arrangement, the for-profit manager may be indistinguishable from an owner who receives nearly all or most of the business' revenues and bears the requisite level of liability and costs.

Evidence of how for-profit management firms are actually compensated is hard to find. Its last public filing before it went private suggests that Edison Schools, the nation's largest for-profit education management company,<sup>44</sup> typically receives a large fee and pays its own operating expenses out of that fee.<sup>45</sup> But it is unclear if Edison's experience is typical. Only a handful of for-profit education management organizations are public companies subject to filing requirements under the securities laws, so little is known about their

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43. The California Charter Academy (CCA) is perhaps the highest profile example. While facing bankruptcy and a state investigation in 2004, the nonprofit company closed sixty schools. The investigation revealed that the chief executive of CCA also happened to be the chief executive of the for-profit firm that managed most of the schools opened under CCA's charters. Jennifer Coleman, *State Expands Investigation of Charter School*, ASSOC. PRESS, Aug. 9, 2004, available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/news/archive/2004/08/09/state1852EDT0094.DTL>; Molnar, *supra* note 32, at 27-28; see also *id.* at 30 (describing instances in which for-profit management firms have "set up non-profit entities that appear to be little more than fronts for the for-profit firm").

44. MOLNAR ET AL., *supra* note 46, at 28-29.

45. Edison Sch., Inc., Annual Report (Form 10-K/A), at 19 (Sept. 30, 2003) (noting that Edison's contractual partners typically "provide [Edison] with per-student funding generally comparable to that received by other schools in the district and give us substantial control over a school"); *id.* at 12 (noting that Edison arranges for a facility in most of the charter schools it manages). For an example of a highly ambiguous compensation arrangement involving another company, see Molnar, *supra* note 32, at 32.

operations.<sup>46</sup> These companies naturally hesitate to share the details of their management contracts with anyone other than potential investors.<sup>47</sup>

The place that hybrid schools occupy on the for-profit-nonprofit continuum affects how closely economic models developed to describe for-profit firms can be applied to hybrid schools. Hybrid schools that hire for-profit managers only for limited purposes may closely emulate pure nonprofit schools in their economic behavior. On the other hand, hybrid schools in which the for-profit management firms' control and incentive are powerful enough may behave similarly to schools fully owned and operated by for-profit entities. For example, if a for-profit management firm controls all of the day-to-day and strategic operations of a hybrid school,<sup>48</sup> and the firm's compensation turns in some way on its ability to minimize costs and maximize revenue, a hybrid school has nearly the same incentive and capacity to lower costs and increase revenue as a pure for-profit school. In such situations, the management company internalizes most of the upside and downside of owning the firm. It also enjoys most of the control, as the nonprofit charter-holding firm is unlikely to exercise meaningful authority. Even if a non-profit board is more than a stand-in created by the for-profit management firm to obtain the charter, the for-profit management firm's control may be so complete that firing it would be akin to closing the school.

In keeping with this understanding of hybrid for-profit firms, in the rest of this Note I use the term "for-profit" to refer both to pure for-profit schools and to hybrid schools in which the for-profit management firms' involvement is so deep that the schools function, in economic terms, like for-profit firms. Similarly, I count as "nonprofit schools" hybrid schools in which the for-profit management firms' involvement is too small to distinguish the schools from pure nonprofit schools.

Table 1 compares the number of nonprofit and for-profit schools, as I have defined them, in the charter school market. These data, taken from annual reports issued by Arizona State University (ASU), illustrate that nonprofits have consistently dominated the charter school market since 1998-1999, the first school-year for which comparative figures are available. Although for-profits have never come close to competing with nonprofits for market leadership, they have nonetheless maintained a presence that must be accounted for.

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46. ALEX MOLNAR ET AL., EDUC. POLICY STUDIES LAB., ARIZ. STATE UNIV., PROFILES OF FOR-PROFIT EDUCATION MANAGEMENT COMPANIES SEVENTH-ANNUAL REPORT 2004-2005, at 22-23 (2005).

47. Molnar, *supra* note 32, at 31.

48. Most hybrid schools fit this description. See *supra* notes 36-38 and accompanying text.

Table 1.  
FOR-PROFIT CHARTER SCHOOL MARKET SHARE, 1998-2005<sup>49</sup>

SCHOOL YEAR	TOTAL CHARTER SCHOOLS	FOR-PROFIT CHARTER SCHOOLS	FOR-PROFIT MARKET SHARE
1998-1999	928	104	11%
1999-2000	1341	128	10%
2000-2001	1710	213	12%
2001-2002	2089	300	14%
2002-2003	2436	320	13%
2003-2004	2744	376	14%
2004-2005	3201	436	14%

There are two limitations in these data worth noting. First, the ASU report included as for-profits only schools that were completely managed by for-profit entities. That is, the ASU report did not consider a hybrid school to be under for-profit management if the for-profit firm had anything less than total control over the school's day-to-day and strategic operations. This may bias the number of for-profit schools slightly downward, if we think a hybrid school may act like a for-profit firm even when it's under less than total control by a for-profit firm. Second, the report likely failed to include some hybrid schools managed by small for-profit firms.<sup>50</sup> For-profit companies with only one or two schools under management tend to keep a low profile, which makes them difficult to find and identify in a nationwide study. This biases the percentage of charter schools downward, since it means there are hybrid charter schools out there that the ASU study did not find. The ASU study's disproportionate

49. Total charter school numbers are taken from The Ctr. for Educ. Reform, *Operational Schools by Year Opened* (2005), [http://www.edreform.com/\\_upload/operation-year-octo05.pdf](http://www.edreform.com/_upload/operation-year-octo05.pdf). For-profit charter school numbers are taken from a series of annual studies done at Arizona State University from 1998 to 2005. *E.g.*, ALEX MOLNAR ET AL., *EDUC. POLICY STUDIES LAB., ARIZ. STATE UNIV., PROFILES OF FOR-PROFIT EDUCATION MANAGEMENT COMPANIES 1998-1999* (1999). I rely on the data from the Center for Education Reform for total charter schools because the Department of Education relied on this data in the most recent PCSP Report and because the data closely track the figures the Department of Education used for earlier years in that report. PCSP EVALUATION, *supra* note 31, at 4 exhibit 1-3. I prefer the Center for Education Reform data to the Department of Education's data because they are more current.

50. MOLNAR ET AL., *supra* note 46, at 22.

failure to find small for-profit operators is primarily important for my conclusions about for-profit firms' tendency to operate at large scales.<sup>51</sup>

## II. EXPLAINING NONPROFIT DOMINANCE

In this Part, I argue that nonprofits dominate the charter school market because they control agency costs more efficiently than for-profits do. In Section A, I explain Henry Hansmann's "contract failure" theory of nonprofit organizations, focusing on the theory's prediction that industries characterized by high monitoring and agency costs tend to be dominated by nonprofits. In Section B, I argue that this theory fits the charter school market because monitoring and agency costs are high for many of the constituencies that influence charter schools' survival. In Section C, I analyze in detail how the constraints of the nonprofit form reduce agency and monitoring costs in charter schools. In Section D, I consider some alternative theories to explain nonprofit entities' dominance of the charter school market.

### A. Contract Failure Theory

Although economists have yet to settle on a paradigmatic general theory of nonprofit firms, the last two and a half decades have seen Henry Hansmann's contract failure theory begin to prevail.<sup>52</sup> The theory emphasizes nonprofits' ability to reduce the inefficiencies stemming from high monitoring costs. Hansmann explains the theory succinctly:

[N]onprofit firms serve particularly well in situations characterized by . . . "contract failure" – that is, situations in which, owing either to the

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51. See *infra* notes 108-111 and accompanying text.

52. See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter Hansmann, *The Role of Nonprofit Enterprise*]; see also HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 227-45 (1996); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981) [hereinafter Hansmann, *Reforming Nonprofit Corporation Law*]; Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981). Burton Weisbrod's theory has also received much recognition. Weisbrod has argued that nonprofits supply public goods to individuals who demand more of the goods than the government is able to supply. In Burton's theory, the government does not supply these goods efficiently because it is incapable of pricing to reflect the benefits generated by the good. Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 171, 173-83 (Edmund S. Phelps ed., 1975). There are other contenders in the field of nonprofit theory. See, e.g., A. G. Holtmann, *A Theory of Non-Profit Firms*, 50 ECONOMICA 439 (1983).

nature of the service in question or to the circumstances under which it is produced and consumed, ordinary contractual devices in themselves do not provide consumers with adequate means for policing the performance of producers. In such situations, the nonprofit form offers consumers the protection of another, broader "contract" — namely, the organization's commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide.<sup>53</sup>

Contract failure may occur for a variety of reasons. Consumers may be unable to compare different producers, make a clear bargain about the nature of the goods and the price to be paid, evaluate a product, or enforce a bargain.<sup>54</sup> In situations characterized by contract failure, producers can cut quality in ways that consumers either can't perceive or to which they can't respond. For-profit firms are particularly dangerous to consumers in these situations because the owners of these firms benefit from whatever surplus the firms gain from their customers' losses.

Consumers respond to this problem by turning to nonprofit firms who act somewhat like fiduciaries on their behalf. Nonprofit firms can serve this function because state law prohibits them from distributing profits to shareholders.<sup>55</sup> These firms must plow their earnings back into their businesses and devote themselves to serving patrons.<sup>56</sup> This "nondistribution constraint"<sup>57</sup> assures patrons that the firm has little incentive to take advantage of them by reducing quality. This is important for patrons who cannot verify directly that the firm is treating them fairly.

Hansmann offers a number of examples of nonprofit organizations that fit this mold, such as CARE and the American Red Cross, which receive money from donors to subsidize demand among the poor for necessities like food and clothing. Hansmann argues that although it may seem odd, for-profit firms could conceivably provide this same service: for example, they could provide *X* pounds of rice to a person in Africa in exchange for *Y* dollars from a donor in the United States. For-profit firms rarely provide this kind of service, however, because monitoring costs are too high; a donor in the United States has almost no way of knowing how well a firm is subsidizing demand in Africa. In the absence of mechanisms for directly verifying a firm's performance, the donor does the next best thing: She gives her money to a nonprofit firm that, because

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53. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 52, at 506-07.

54. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 52, at 843.

55. *Id.* at 838.

56. HANSMANN, *supra* note 52, at 228.

57. *Id.*

of the nondistribution constraint, has little incentive to cut quality in unverifiable ways.<sup>58</sup>

### *B. High Monitoring Costs in Charter Schools*

Hansmann's theory can explain the dominance of nonprofit firms in the charter school market. Several interest groups influence a charter school's success and failure, including parents, government agencies, and donors.<sup>59</sup> Each of these groups has goals they want the charter school to meet (generally centering on academic achievement), and each faces significant monitoring costs that prevent them from assessing and enforcing the school's attainment of those goals. These groups face common monitoring problems, including perceiving and measuring students' achievement and enforcing the threat of accountability. Hansmann's theory explains nonprofit dominance as a product of these groups' efforts to reduce monitoring costs. These groups prefer nonprofits because nonprofits offer assurances that managers will not cut costs and quality in imperceptible ways. In the following three Subsections, I explore the monitoring costs each of these groups encounters and explain how these groups respond to monitoring costs by encouraging nonprofit dominance.

#### *1. Monitoring by Parents*

Early charter theory placed a great deal of emphasis on parental monitoring. Early charter theorists argued that schools would live or die based

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58. Hansmann distinguishes between "donative" and "commercial" nonprofits based on their sources of income. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 52, at 840-41. Donative nonprofits receive income from donors who do not directly consume the goods or services. Commercial nonprofits receive income from patrons who directly consume the goods the firms produce. Charter schools exhibit elements of both donative and commercial nonprofits. They are donative because governments and private donors give money to charter schools to act as third-party intermediaries between them and the students; they are commercial because students look a lot like paying customers, bringing and taking government funds with them when they enter and leave.

59. Investors, creditors, and suppliers also play important roles in determining which charter schools succeed. I do not discuss them here, however, because their influence is unlikely to push the charter market in either the nonprofit or for-profit direction. Investors cannot invest in nonprofits, and there appears to be no concrete reason why creditors or suppliers would prefer either for-profits or nonprofits. It is unlikely that monitoring costs matter to creditors and suppliers, since they are primarily interested in charter schools' financial health, rather than their success in educating students. Charter schools have no more ability to obfuscate in financial matters than any other businesses do.



on their ability to gain parents' trust.<sup>60</sup> In fact, parents have had great difficulty monitoring charter schools and holding them accountable. A parent's goal is relatively simple: She wants the best education for her child. But parents face two obstacles in monitoring schools' achievement of this basic goal: (1) measuring and assessing output and (2) enforcing accountability once they become dissatisfied.

The first set of problems is rooted in parents' distance from their children's education. Parents do not sit in classrooms and receive instruction; their children do. Parents, therefore, must resort to proxy measures of schools' output, such as tests and conversations with students and teachers. Each of these has severe limitations. The debate about testing is large and complex, and it need not be rehearsed again here. It is sufficient to point out that tests do not seek to measure many relevant character traits and values that education aims to instill in children, such as self-discipline and cooperation. Tests are especially problematic in assessing idiosyncratic charter schools such as Montessori schools, which make character cultivation a central aim.<sup>61</sup> Additionally, test data may not be easily accessible for parents making decisions. While parents may be able to obtain their own children's test scores, aggregated test data is often hard to acquire. In fact, many states have had severe problems collecting and disseminating information to parents.<sup>62</sup>

Of course, parents can also talk directly to their children and to teachers, but these softer measures have limits as well. Teachers at for-profit schools, for example, may be unreliable sources of information because they feel pressure to speak optimistically to keep students from leaving. Children may also be unreliable: They can be quizzed and questioned, but they often lack the capacity to judge their educational experiences and to articulate those

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60. See, e.g., CHUBB & MOE, *supra* note 6, at 224-25 (arguing that government agencies should not attempt to monitor or evaluate schools on any measures of performance and should only assure parents' access to information); FRIEDMAN, *supra* note 6, at 89.

61. See M.J. Rosanova, *Montessori Elementary Is Different: What Children Study, What Children Do*, MONTESSORI LIFE, Spring 2003, at 8, 9; see also AMY STUART WELLS ET AL., UCLA CHARTER SCHOOL STUDY: BEYOND THE RHETORIC OF CHARTER SCHOOL REFORM 22 (1999), <http://www.gseis.ucla.edu/docs/charter.pdf> (describing tests' inability to measure charter schools' success on unique curricula not oriented to tests).

62. Robert E. Crew, Jr. & Mary Ruggiero Anderson, *Accountability and Performance in Charter Schools in Florida: A Theory-Based Evaluation*, 24 AM. J. EVALUATION 189, 199-200 (2003) (observing that Florida has no central office to gather and disseminate data on charter schools); Gregg Garn, *Moving From Bureaucratic to Market Accountability: The Problem of Imperfect Information*, 37 EDUC. ADMIN. Q. 571, 591, 594-96 (2001) (observing extremely low compliance rates with Arizona's information-gathering program); John S. Rogers, *Creating a Public Accountability for California Schools*, 106 TEACHERS C. REC. 2171 (2004) (observing the general unavailability of useful information about California education).

judgments to parents. Finally, children's goals may conflict with their parents'. A high school student doing poorly at a charter school may prefer to stay at the school because her friends are there, while a parent may prefer her to leave.

A larger problem that plagues almost any method of measuring a school's output is the risk that a child's performance depends on factors beyond a school's control or influence. When a teenager loses interest in school, is it because of the school or because of the teenager? Large-scale studies can sometimes make judgments within reasonable confidence intervals about a school's general effect on students,<sup>63</sup> but the uncertainty is much greater when assessing individual students. Even if a school does well on measures of aggregate student performance, parents have little insight into whether their own children are outliers and could do better elsewhere.

The second major monitoring obstacle is that even when parents can gather and comprehend information, they may be in a poor position to enforce accountability. Children become attached to teachers, friends, and routines, and even if a school is performing worse than other available schools, the psychological and emotional costs of removing a child may well exceed the uncertain gains from putting her in a better school. Additionally, parents may be vulnerable to a sunk-cost bias,<sup>64</sup> irrationally keeping their children in underperforming schools because they do not want to confront the failures of their own judgment.

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63. The challenges of comparing, on a large scale, charter school populations with their conventional public school peers have generated a substantial literature. Numerous researchers have noted that charter and traditional school populations differ in ways that make statistical assessment difficult. See, e.g., NAT'L CTR. FOR EDUC. STATISTICS, U.S. DEP'T OF EDUC., *AMERICA'S CHARTER SCHOOLS: RESULTS FROM THE NAEP 2003 PILOT STUDY* 1, 1-9 (2004) [hereinafter NAEP REPORT] (arguing that only data that disaggregate demographic groups are useful for comparing charter and traditional schools); PCSP EVALUATION, *supra* note 31, at xiv (noting that charter schools disproportionately serve disadvantaged populations); Crew & Anderson, *supra* note 62, at 206 ("The problem is that some charter schools were created to target specific racial groups . . ."); Jay P. Greene et al., *Apples to Apples: An Evaluation of Charter Schools Serving General Student Populations* 6 (Ctr. for Civic Innovation, Educ. Working Paper No. 1, 2003) (attempting to compare performance between similar demographic groups in charter schools and traditional schools); Caroline M. Hoxby, A Straightforward Comparison of Charter Schools and Conventional Public Schools in the United States (Sept. 2004) (unpublished manuscript), available at [http://post.economics.harvard.edu/faculty/hoxby/papers/charters\\_040909.pdf](http://post.economics.harvard.edu/faculty/hoxby/papers/charters_040909.pdf) (comparing students in nearly all U.S. charter schools to nearby schools with similar racial compositions).
64. Cf. Samuel Issacharoff & George Loewenstein, *Second Thoughts About Summary Judgment*, 100 YALE L.J. 73, 113 (1990) (discussing sunk-cost bias in the context of summary judgment).

Parents may also have few alternatives. Most school choice plans are small,<sup>65</sup> and parents thus face a choice between one or perhaps a handful of conventional public schools and one charter school. For parents who prefer idiosyncratic charter schools, such as Montessori schools or schools with particular subject emphases, the choices are particularly limited.

Hansmann's contract failure theory suggests that parents may respond to all of these monitoring problems by preferring nonprofit schools. Though probably unfamiliar with the nondistribution constraint, parents may intuitively recognize their own vulnerability to being cheated and may understand that nonprofit schools not subject to profit motives and shareholder pressure are less likely to cheat them than for-profit schools. Parents' preferences, in turn, influence the shape of the charter school market. If parents don't trust a school, they can refuse to send their children there. Since funding is tied to enrollment, schools without students go out of business. And since parents have reason to prefer nonprofits, it is not surprising that nonprofits dominate the charter school market.

## 2. *Monitoring by Governments*

Government agencies also play an important role in determining charter schools' success. Like parents, government agencies have great difficulty monitoring charter schools. Hansmann's theory therefore suggests that agencies use their influence to encourage nonprofit charters more than for-profit charters.

Government agencies monitor charter schools for their achievement of several goals. First, governments want children to learn the material they're taught. Often this interest overlaps with parents' interests. Occasionally, however, it may bring governments and parents into conflict when parents are unable or unwilling to seek their children's best interests. Governments also have public-good-related goals. These generally do not overlap with parents' interests and may even conflict with them. In a democracy, education serves public ends by molding students into good citizens capable of fulfilling their civic responsibilities.<sup>66</sup> Students' fulfillment of these duties benefits all

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65. Frederick Hess et al., *Small Districts in Big Trouble: How Four Arizona School Systems Responded to Charter Competition*, 103 TEACHERS C. REC. 1102, 1102 (2001).

66. As Horace Mann famously observed, the common school reform movement of the nineteenth century emphasized the importance of "mak[ing] Republicans." LAWRENCE A. CREMIN, *THE AMERICAN COMMON SCHOOL: AN HISTORIC CONCEPTION* 70-71 (1951). Aside from educating children to be good citizens, schools may also serve the public good by creating forums for public participation. See L. Elaine Halchin, *And This Parent Went to*

members of society. Since good citizens do not fully internalize all of the benefits their civic-mindedness brings to society, education is in some senses a public good. Public-good-related interests may bring governments into conflict with parents who prefer bizarre anti-social curricula, or (more likely) curricula that emphasize specialized subject areas at the expense of subjects that might transform children into better citizens.<sup>67</sup> Governments also have distributional goals, which motivate them to ensure certain norms of equal access and compliance with disability and nondiscrimination laws.<sup>68</sup>

Governments, however, have their own limitations. First, government agencies face many of the same output-assessment and accountability-enforcement problems that parents do. Second, goal-definition may be more difficult for government agencies than for parents, because agencies must reconcile competing ideas of educational success. Third, information-gathering problems are in many ways more complex for governments, which are far removed from individual children and must discern broad trends and make large-scale policy judgments. In making these judgments, governments must rely more heavily on tests than parents do.<sup>69</sup> Finally, agencies face obstacles to using the limited regulatory mechanisms that charter school statutes provide to enforce accountability. Although charter school theorists emphasize the threat of government-mandated closure, such closures have been rare.<sup>70</sup> Charter schools often become deeply politically entrenched and even underperforming

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*Market: Education as Public Versus Private Good, in SCHOOL CHOICE IN THE REAL WORLD: LESSONS FROM ARIZONA CHARTER SCHOOLS* 19, 30, 34 (Robert Maranto et al. eds., 1999). But see CHUBB & MOE, *supra* note 6, at 31-32 (arguing that public schools alienate parents by restricting their participation).

67. See, e.g., CAROL ASCHER ET AL., *HARD LESSONS: PUBLIC SCHOOLS AND PRIVATIZATION* 9 (1996); BRIAN P. GILL ET AL., *RHETORIC VERSUS REALITY: WHAT WE KNOW AND WHAT WE NEED TO KNOW ABOUT VOUCHERS AND CHARTER SCHOOLS* 17 (2001); Halchin, *supra* note 66, at 20, 25; Note, *The Hazards of Making Public Schooling a Private Business*, 112 *HARV. L. REV.* 695, 697-98 (1999).
68. See 20 U.S.C.A. § 7221i(1)(G)-(H) (West 2003) (requiring lottery-based admission and compliance with nondiscrimination laws for Public Charter Schools Program grant eligibility).
69. See *supra* note 63.
70. *CTR. FOR EDUC. REFORM, CHARTER SCHOOL CLOSURES: THE OPPORTUNITY FOR ACCOUNTABILITY* 3 (2002) (finding that only 6.7% of charter schools nationwide had been closed by government agencies); *PCSP EVALUATION, supra* note 31, at 47 (finding that only six percent of charter schools in a national sample failed to have their charters renewed after the initial charter period expired); *id.* at 50 exhibit 4-8 (finding that a majority of charter authorizers reported a high degree of difficulty closing schools).

schools tend to gather support.<sup>71</sup> A group of researchers who participated in a UCLA-sponsored study of California charter schools has argued that “holding charter schools accountable [i]s as much a political process as it [i]s an administrative matter.”<sup>72</sup> Charter schools have fought at least as vigorously in political and bureaucratic settings as in the market for students.<sup>73</sup>

Government monitoring has also been hampered by a wide range of failings that, though not inherent in charter theory, arise frequently in practice. For example, charter schools and government agencies are often uncertain about the scope of the government’s monitoring authority.<sup>74</sup> The most recent study of the Public Charter School Program found that “charter school legislation in the states has provided virtually no guidance on how authorizers should approach accountability processes.”<sup>75</sup> One charter operator in California and his district superintendent disagreed even about whether the charter school had to meet the district’s achievement standards or could set its own.<sup>76</sup> In Arizona, which has long been a leading charter school state, researchers observed similar uncertainty.<sup>77</sup> Such vagueness in a monitoring agency’s mandate can profoundly cripple the agency in the politicized charter environment.<sup>78</sup>

Monitoring agencies also frequently lack adequate resources. In fact, most monitoring bodies have no staff specifically devoted to charter school issues at

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71. Amy Stuart Wells et al., *The Politics of Accountability: California School Districts and Charter School Reform*, 11 STAN. L. & POL’Y REV. 325, 329-30 (2000) (finding that similarly performing charter schools were more likely to be shut down in districts where school boards had strong political support than in districts where school boards had weaker support).

72. *Id.* at 326.

73. See Jeffrey R. Henig et al., *Privatization, Politics, and Urban Services: The Political Behavior of Charter Schools*, 25 J. URB. AFF. 37 (2003).

74. Vergari, *supra* note 30, at 731 (“Across the states, there is a lack of clear understanding about what charter schools are responsible for, to whom they are responsible, and when they will be held accountable.”).

75. PCSP EVALUATION, *supra* note 31, at 35.

76. Wells et al., *supra* note 71, at 335.

77. Gregg A. Garn & Robert T. Stout, *Closing Charters: How a Good Theory Failed in Practice*, in SCHOOL CHOICE IN THE REAL WORLD, *supra* note 66, at 142, 143 (“Although policy makers [in Arizona] focused intently on dismantling the bureaucratic entanglements for charter schools, they neglected to articulate how state agencies should deal with charter schools in a market-based context.”).

78. See Vergari, *supra* note 30, at 738.

all.<sup>79</sup> The symptoms of this problem have included limited communication between agencies,<sup>80</sup> poor information gathering, and, in some states, the failure of any agency to take responsibility for assessing charter school performance.<sup>81</sup> What few resources agencies devote to charter schools may have limited effect because charter schools often fail to set clear and measurable goals for themselves.<sup>82</sup>

The challenges government agencies face in monitoring charter schools are evident in agencies' emphasis on indirect forms of monitoring and regulation. Agencies tend to hold charter schools accountable primarily for failures to comply with financial regulations, nondiscrimination regulations, and other definite but narrow rules, rather than for shortcomings in academic performance.<sup>83</sup> Additionally, many charter schools receive no more autonomy

79. PCSP EVALUATION, *supra* note 31, at 38 (finding that in 2001 only approximately one-third of authorizers had an office or staff dedicated to monitoring charter schools); Vergari, *supra* note 30, at 746 (quoting an audit by the Massachusetts Inspector General finding that local chartering agencies had insufficient resources to monitor charter schools effectively).

80. Garn & Stout, *supra* note 77, at 149, 151.

81. Crew & Anderson, *supra* note 62, at 199-200 (finding that, although Florida's education agency required regular financial and student performance reporting by charter schools, "no one in Florida's educational system has taken responsibility for annual analysis and reporting of the data that were included in these reports"). One former associate superintendent at the Arizona Department of Education told a researcher that before the department initiated a new information-gathering program in 1996, "[w]e would hear horror stories or parents would call in with these unbelievable tales of stuff, and nobody really knew what was happening, nobody knew if the schools were delivering what they said they would. Were they complying with their charter or not? Nobody really knew." Garn, *supra* note 62, at 584.

82. WELLS ET AL., *supra* note 61, at 6; Crew & Anderson, *supra* note 62, at 203; Frederick M. Hess & Robert Maranto, *Letting a Thousand Flowers (and Weeds) Bloom: The Charter Story in Arizona*, in *THE CHARTER SCHOOL LANDSCAPE* 54, 65 (Sandra Vergari ed., 2002); Wells et al., *supra* note 71, at 334.

83. The scholarly literature is remarkably unanimous on this point. See, e.g., Bryan C. Hassel, *Balancing Acts: What Charter Schools Teach Us About Government-Nonprofit Contracting*, 26 *NONPROFIT & VOLUNTARY SECTOR Q.* 442, 452-53 (1997) (observing the existence of intense government monitoring of regulatory compliance and weak government monitoring of academic achievement and performance). For example, the Arizona Department of Education (ADE) is much more likely to monitor and enforce financial and regulatory rules than academic performance standards. See Garn, *supra* note 62, at 584 (quoting an ADE staff member saying: "We did not do a programmatic audit in that we did not look at quality or the process of education . . . . What we were monitoring were those things that have either legal or statutory compliance or charter compliance, meaning that they were doing things that either weren't in their charter, or they weren't doing things that were in their charter. So, we looked for the compliance in state and federal statutes."); Hess & Maranto, *supra* note 82, at 67 (finding that most of the nineteen charter school closings in the Arizona program's first four years were motivated by financial and regulatory problems, and that all

from input-based regulation than conventional public schools do, presumably because many regulators do not trust their ability to control charters through output-based monitoring.<sup>84</sup> This reality contrasts with charter theory and statutory program design. Most charter authorizers and monitoring agencies claim to monitor academic performance.<sup>85</sup> Indeed, output-based accountability is a central theme in the charter school movement. But academic performance is so difficult to measure and so open to controversy that poor academic performance has resulted in few school closings.

Hansmann's contract failure theory predicts that in response to these monitoring difficulties government agencies will prefer dealing with nonprofit charter schools. Though direct evidence of agencies' preference for nonprofits is hard to find, agencies may have encouraged nonprofits in a number of ways. Agencies determine which schools may open and how long they may operate. In practice, the scrutiny chartering agencies apply to new charter applications may vary widely. But when such scrutiny is meaningful, chartering agencies may be more likely to approve nonprofit schools than for-profit schools because the agencies may recognize the deficiencies in their own ability to monitor. Additionally, to reduce their monitoring costs, agencies may design and police nonstatutory regulations in ways that are unfriendly to for-profit charter schools.

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forced charter closings resulted from financial abuses). Regulatory agencies in other states have acted similarly. See, e.g., OFFICE OF PROGRAM POLICY ANALYSIS & GOV'T ACCOUNTABILITY, FLA. STATE LEGISLATURE, REPORT NO. 05-11, CHARTER SCHOOL APPLICATION REQUIREMENTS ARE REASONABLE; FINANCIAL MANAGEMENT PROBLEMATIC 10 (2005) [hereinafter FLORIDA REPORT] ("Financial problems were the most frequently cited reason for the closure of Florida charter schools . . ."); PCSP EVALUATION, *supra* note 31, at 49 (finding that financial problems and problems complying with regulations were the two most frequently cited reasons for formal sanctions by authorizers, including charter school closure, across the country); Crew & Anderson, *supra* note 62, at 201 (finding that among nineteen Florida charter closures studied, only one cited academic performance as the primary reason for closure); Wells et al., *supra* note 71, at 334 (noting that in California "district officials [were] much more likely to hold charter schools accountable on fiscal rather than academic measures").

84. PCSP EVALUATION, *supra* note 31, at 31; UTAH FOUND., *supra* note 19, at 1; Wells et al., *supra* note 71, at 326 ("[I]n many instances, the amount of autonomy and the degree of accountability that charter schools experienced were often no more or less than those of the non-charter public schools."); see also Hassel, *supra* note 83, at 454 (noting that compliance with regulations occupies an inordinate amount of charter school administrators' time).
85. PCSP EVALUATION, *supra* note 31, at 43 (finding that ninety-one percent of charter school monitoring agencies claim to monitor student achievement on statewide performance assessments).

3. *Monitoring by Donors*

Unlike conventional public schools, some charter schools attract substantial donations. Because donors' money plays an important role in determining which schools succeed and which fail, donors' tendency to choose nonprofits may also help explain the shape of the charter school market. To understand the ways in which donors incur monitoring costs, it is important to understand the forms donations take. Charter donors make their contributions in a wide variety of ways. First, they contribute cash. It is difficult to pin down exactly how much money private donors have given charter schools, but a recent U.S. Department of Education study found that the great majority of states reported private cash donations as sources of startup funds for charter schools.<sup>86</sup> Anecdotal evidence also suggests that donations have been important to many charter schools.<sup>87</sup> This evidence is bolstered by the fact that many states, either deliberately or inadvertently, give charter schools less money than conventional public schools, making donations important.<sup>88</sup>

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86. PCSP EVALUATION, *supra* note 31, at 16.

87. WELLS ET AL., *supra* note 61, at 37 (describing a charter school that received forty percent of its funding from private donors and a school that operated in a donated building); *id.* at 38 (observing that every school in the study attempted to obtain grants from private foundations, the State of California, or the business community); *id.* at 41 (describing a charter leader who used his personal connections to gather grants and donations for his school); *see also* POLICY & PROGRAM STUDIES SERV., U.S. DEP'T. OF EDUC., A DECADE OF PUBLIC CHARTER SCHOOLS 59 (2002) (observing that some charter authorizers helped schools seek private donations); Telephone Interview with Dacia Toll, Dir., Amistad Acad., in New Haven, Conn. (Mar. 5, 2005) ("Even though we raise a lot of money, it doesn't completely close the gap between charter and regular school funding. In the context of Connecticut charter schools, you have to raise a lot of money."). *But see* UTAH FOUND., *supra* note 19, at 4 fig.2 (indicating that only 7.2% of Utah charter schools' total revenue from 2000 to 2002 came from private cash or in-kind donations).

88. *See* THOMAS B. FORDHAM INST., CHARTER SCHOOL FUNDING: INEQUITY'S NEXT FRONTIER 1 (2005), <http://www.edexcellence.net/institute/charterfinance> (follow "View the Complete Report" hyperlink). Often, states underfund charter schools by giving them only the revenues that conventional public schools receive from the state governments, but not the revenues conventional public schools receive from local sources, such as property taxes. Hassel, *supra* note 83, at 455. For example, Colorado provides charter schools with eighty percent of the funding that traditional school students receive, and allows charter schools to negotiate with the districts that authorize them for more money. *See* COLO. REV. STAT. ANN. § 22-30.5-112-2(a)(I), (c)(I) (West 2005). Connecticut also deliberately underfunds charters. Marcelo Marlow Blackburn, Accounting for Amistad Academy: The Relationship Between Charter School Accountability and One School's Success 25 (2004) (unpublished manuscript, on file with author). Some states, such as Arizona and Massachusetts, attempt to fund charter students and traditional school students equally. *See* ARIZ. REV. STAT. ANN. § 15-185 (Supp. 2005); MASS. GEN. LAWS ANN. ch. 71, § 89 (Supp. 2005). *But* defining



Second, donors contribute volunteer labor. Many researchers have found that charter schools generally get more out of parents and volunteers than traditional schools do.<sup>89</sup> This labor may not be as useful as skilled paid labor, and it may inefficiently distort charter schools' choices away from cash-and-capital-intensive instructional methods (such as computers) to labor-intensive methods (such as supervised reading and games). But volunteerism can come in the form of valuable skilled labor as well. Amistad Academy, a highly successful charter school in New Haven, Connecticut, for example, has on its board several prominent community members who volunteer their fundraising, finance, and management expertise.<sup>90</sup>

Finally, nonprofit charter schools often attract talented and energetic managers and teachers who forego higher salaries in private schools or other industries to pursue their passion for education.<sup>91</sup> It may seem strange to think of these skilled workers as "donating" their labor, but the economic effect is similar to volunteerism. The enthusiasm and skill of undercompensated workers may well be the most significant factors driving charter school success.<sup>92</sup> Amistad Academy, for example, was founded and operated by a group of prominent community members led by Dacia Toll, a Yale Law School graduate and Rhodes Scholar with substantial management expertise. Toll says that were it not for the opportunity to become involved in a charter school on her own terms, she probably would not have entered public education.<sup>93</sup>

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"equal" can be extremely difficult. School funding sources are many and varied, and they are often conditioned on particular school characteristics, making direct comparisons unhelpful. See UTAH FOUND., *supra* note 19, at 4-7.

89. PCSP EVALUATION, *supra* note 31, at 28; POLICY & PROGRAM STUDIES SERV., *supra* note 87, at 20; UTAH FOUND., *supra* note 19, at 4; *id.* at 38 (describing "parental and in-kind support," much of it in the form of volunteer labor); Henry J. Becker et al., *Parental Involvement Contracts in California's Charter Schools: Strategy for Educational Improvement or Method of Exclusion?*, 98 TEACHERS C. REC. 511 (1997); Richmond, *supra* note 59, at 358-59.
90. Interview with Dacia Toll, *supra* note 87; see also WELLS ET AL., *supra* note 61, at 30 (describing a high-level district administrator who donated a large amount of time to help a charter school begin operating).
91. This phenomenon is not unique to nonprofit charter schools. Nonprofit firms in other industries also tend to attract workers for below-market compensation. See *infra* note 101 and accompanying text.
92. Walker Richmond, *Charter Accountability: Rhetoric, Results, and Ramifications*, 12 VA. J. SOC. POL'Y & L. 330, 331 (2004) ("[C]harter schools' most significant strength is not their accountability to external actors but rather their ability to harness the shared commitment and energies of the internal actors.").
93. Interview with Dacia Toll, *supra* note 87 ("We have the keys to the car. We have total control over budget and hiring. We have everything within our power to make this a truly great school. It would be demoralizing to get involved and have control taken out of our hands.")

Teachers appear to derive satisfaction from the perception that charter schools are more flexible, collegial, and serious about success.<sup>94</sup> As a result, these teachers may work harder and may stay in publicly funded education longer than they otherwise would.

Donors face many of the same monitoring problems that agencies and parents do. Because children's achievement is so difficult to measure, and because the risk that children's achievement is influenced by forces outside of the schools' control is great,<sup>95</sup> donors may hesitate to give their money and time to for-profits. Donors' ability to monitor may depend to some extent on the form the donations take. Perhaps some large cash donors, important volunteers, and underpaid employees are in better positions to monitor charter schools than parents and agencies are. They may be able to gain something like insider status, sitting on charters' boards or participating in their management and decisionmaking.

Even if some donors have some ability to monitor and enforce accountability, there are enough schools vying for these donors' money that even small differences between for-profit and nonprofit schools in the difficulty of monitoring may cause donors to offer their money and services to nonprofits. If that is so, nonprofit schools gain a competitive edge by having access to donated funds and labor. It is difficult to say exactly how strongly donors have influenced the makeup of the charter market, for the same reasons it is difficult to say how much donors contribute. Contract failure theory, however, strongly suggests that donors will favor nonprofit charter schools.

### *C. Enforcement of the Nondistribution Constraint in Charter Schools*

We now have some sense of the problems parents, agencies, and donors face in monitoring charter schools. We also know that Hansmann's contract failure theory suggests that these constituencies will use their influence to encourage the growth of nonprofits as a solution to these monitoring problems. In this Section, I turn to the question of how exactly nonprofits solve monitoring problems. The nondistribution constraint in nonprofit charters provides parents, governments, and donors a guarantee that the schools will not cut quality in ways these constituencies cannot perceive to increase shareholders' profits. In this regard charter schools are a typical instance of the general contract failure story.

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94. PAUL T. HILL ET AL., CHARTER SCHOOLS AND ACCOUNTABILITY IN PUBLIC EDUCATION 5 (2002); Courtney L. Malloy & Priscilla Wohlstetter, *Working Conditions in Charter Schools: What's the Appeal for Teachers?*, 35 EDUC. & URB. SOC'Y 219 (2003).

95. See *supra* text accompanying note 63.

Ordinarily, the nondistribution constraint is enforced by state attorneys general, the IRS, or, in a small number of states, patron lawsuits.<sup>96</sup> This kind of enforcement is as plausible in the charter school industry as in any other. Nonprofit charter schools may be subject to closer policing on the nondistribution constraint than nonprofits in other industries, though, because charter schools are regulated heavily in other aspects of their businesses. The nondistribution constraint may sometimes be enforced by state boards of education or other charter regulatory agencies.<sup>97</sup> Although charter regulators have many failings, they appear to police charter school finances relatively well.<sup>98</sup> These efforts may indirectly (and inadvertently) have an effect similar to enforcement of the nondistribution constraint. In the process of auditing charter schools and scrutinizing the way they use government funds, charter regulators may stumble across violations of the nondistribution constraint. Many charter closures have resulted from discoveries of the deliberate mismanagement and indirect profit distributions that typify violations of the nondistribution constraint in more conventional industries.<sup>99</sup> Sometimes charter regulators recognize this kind of dubious conduct as a violation of state nonprofit corporation laws and may enforce those laws directly or report violations to state attorneys general. It is also possible that charter regulators process violations of the nondistribution constraint as violations of charter-school-specific financial regulations or regulations requiring charter schools to comply with all relevant state laws. They may, for example, require particular funds to be spent in particular ways, or may place tight limits on the way schools use public funds. In any event, the effect is the same.

Besides inviting direct and indirect enforcement of the nondistribution constraint, the nonprofit form may also constrain charter schools in extralegal ways. Hansmann has argued that the social norms associated with nonprofit enterprise may be more effective than the threat of legal sanctions in policing

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96. Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 52, at 600-13.

97. I could find no documented instance of a state attorney general enforcement action against a charter school for violation of the nondistribution constraint. Such enforcement of the nondistribution constraint is rare in all industries. *Id.* at 601; *see also* Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Nonprofit Health Care Enterprise*, 5 *YALE J. HEALTH POL'Y L. & ETHICS* 1, 1-2 (2005).

98. As noted above, this may stem partly from an effort to compensate for regulators' inability to directly control charters' performance on measures of student achievement. *See supra* note 83 and accompanying text.

99. *CTR. FOR EDUC. REFORM*, *supra* note 70, at 6-18, 31 (detailing the reasons for 154 charter school closures across the country and listing mismanagement separately from financial reasons in many closures).

the nondistribution constraint.<sup>100</sup> A significant empirical literature has demonstrated that workers at nonprofit firms are willing to accept lower pay than their similarly qualified peers at for-profit firms in exchange for the extra satisfaction that comes from working at nonprofit firms.<sup>101</sup> Since nonprofit charter schools are often filled at least partly with teachers who believe in the schools' missions,<sup>102</sup> nonprofit charters may be less likely to take advantage of parents' and agencies' inability to monitor than for-profit charters are.

#### *D. Alternative Explanations for Nonprofit Dominance*

Contract failure is not the only way to understand nonprofit dominance. Several alternative explanations help to account for the makeup of the charter school market. However, because these alternative explanations have limited capacity to explain the charter market, contract failure appears to be the most significant factor driving nonprofits' relative success.

The most obvious alternative explanation is state law: Most states prohibit for-profit corporations from receiving charters. This explanation is less promising than it initially appears because it cannot account for the infrequency of hybrid schools in most states. Only six of the forty-one states with charter laws statutorily prohibit hybrid schools.<sup>103</sup> If legal restrictions on direct charter-holding were the only obstacle to greater for-profit presence in the market, then hybrid schools that avert legal restrictions but functionally approximate for-profit schools would be more common than they are.

Another possible explanation is that charter schools are simply unprofitable. Reliable data on the profitability of charter schools is extremely difficult to find, so it is hard to assess the premise of this explanation directly.<sup>104</sup> But such data would illuminate little.<sup>105</sup> It goes almost without

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100. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 52, at 875.

101. See, e.g., ROBERT H. FRANK, WHAT PRICE THE MORAL HIGH GROUND? ETHICAL DILEMMAS IN COMPETITIVE ENVIRONMENTS 76-78 (2004); Anne E. Preston, *The Nonprofit Worker in a For-Profit World*, 7 J. LAB. ECON. 438 (1989); Burton A. Weisbrod, *Nonprofit and Proprietary Sector Behavior: Wage Differentials Among Lawyers*, 1 J. LAB. ECON. 246 (1983). But see Myron J. Roomkin & Burton A. Weisbrod, *Managerial Compensation and Incentives in For-Profit and Nonprofit Hospitals*, 15 J.L. ECON. & ORG. 750, 754 (1999) (arguing that the existing empirical literature may overstate wage differences between nonprofit and for-profit workers because studies fail to control adequately for less stressful and demanding work environments at nonprofit firms).

102. See *supra* notes 91-94 and accompanying text.

103. EDUC. COMM'N OF THE STATES, *supra* note 32, at 4 tbl.3.

104. MOLNAR ET AL., *supra* note 46, at 5.

saying that it's hard to turn a profit in for-profit charter schools. If it weren't, there would be more such schools. The real question, then, is not whether for-profit charters are unprofitable, it's why. The contract failure theory I have espoused allows us to move beyond the somewhat tautological observation that for-profits are not particularly profitable and begin to understand the reasons why this is so.

A related explanation is that charter schools are unprofitable because their revenues are fixed. The amount of money that follows each child to a charter school remains static, no matter how much the school spends on its operations. For-profits cannot make money, the argument goes, because they cannot charge enough. This argument has the same problem that the general unprofitability argument does: It fails to explain why nonprofits are capable of operating with fixed revenues while for-profits are not. More important, pricing is a function of both quality and revenue. Even if revenues are fixed, for-profit schools can simulate price increases by lowering quality. As long as revenues exceed costs, profits are possible, regardless of whether revenues are fixed. Imagine, for example, a for-profit school situated in a neighborhood where the conventional public schools are so bad that the for-profit school can attract a large student body merely by putting a roof on the building.<sup>106</sup> Such a school could easily turn a profit by running a bare-bones operation just slightly better than the local conventional public school.

It is possible that, given fixed revenues, the return to capital on even bare-bones for-profit charter schools is simply too low for investors. One of the major differences between for-profits and nonprofits is that for-profits need to compete not only with other charter schools but also with other investment opportunities, and for-profit schools may be unable to match these opportunities with fixed revenues. Fixed revenues need not supplant contract failure as the major explanation of nonprofit dominance, however. Fixed revenues are problematic only if costs are high. And contract failure theory helps to explain high costs with reference to the challenges of overcoming the skepticism of parents, regulators, and donors.

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105. This isn't entirely true. If for-profit charters turned out to be tremendously profitable, then we might think that barriers to entry or some other market imperfection was responsible for the scarcity of for-profits.

106. The *Las Vegas Sun* describes one such possible situation in my home school district in rural Nevada: "[T]he [local public high] school is marred by physical anomalies. Classrooms the size of one-car garages. A sieve-like roof over one building that doesn't so much keep out the rain as strain it. Fissures that fan out like spilled ink across the exterior walls of the main building." Martin Kuz, *Rural Schools Are Crumbling*, *LAS VEGAS SUN*, Apr. 25, 1999, <http://www.lasvegassun.com/sunbin/stories/sun/1999/apr/25/508711174.html>.

### III. EXPLAINING FOR-PROFIT EXISTENCE

Given that monitoring costs in for-profit charters are so high, it seems strange that any parents, agencies, or donors would prefer for-profits. Since nonprofits control agency costs more efficiently than for-profits do, why do for-profits exist at all? The answer lies in for-profit schools' superior ability to raise capital and to exploit economies of scale.

There is ample evidence to suggest that most for-profit charter schools operate at a larger scale than nonprofit schools do. Scale in schools can be measured both in individual school size and in school network size.<sup>107</sup> The available evidence indicates that for-profit charter schools are larger than nonprofits along both dimensions. Heath Brown recently measured and compared for-profit and nonprofit charter school scale on both dimensions in a four-state survey. Brown found that for-profit charters tend to operate larger individual schools and to centralize administrative functions into network offices at a higher rate than nonprofit charters do.<sup>108</sup> Other evidence supports Brown's finding on network size. The ASU study surveyed 436 for-profit charter schools across the country in 2004-2006 and found that 336—about seventy-seven percent—were operated by firms that had networks of ten or more schools.<sup>109</sup> The data in the ASU report must be taken with a grain of salt, since they probably omit a disproportionate number of small for-profit operators. But data from a more detailed report on Michigan charter schools also support this story.<sup>110</sup> In 1999-2000 in Michigan, 24 of the 122 for-profit schools were operated by firms that controlled one or two schools, 36 were operated by firms with three to six schools and 62 were operated by firms with more than six schools. Three firms together operated a total of 55 schools. The ASU report also supports Brown's findings on individual school size. The ASU authors found a strong tendency among management companies with large networks to operate individual schools larger than the national charter school average.<sup>111</sup>

For-profit schools' ability to run large networks stems largely from their superior access to capital, the most essential ingredient in economies of scale.

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107. For a detailed discussion of the various methods of measuring scale in schools, see Craig Howley, *Small Schools*, in *SCHOOL REFORM PROPOSALS: THE RESEARCH EVIDENCE* §§ 3.2-3.5 (Alex Molnar ed., 2002).

108. Heath Brown et al., *Scale of Operations and Locus of Control in Market- Versus Mission-Oriented Charter Schools*, 85 *SOC. SCI. Q.* 1035, 1042-44 (2004).

109. MOLNAR ET AL., *supra* note 46, at 3, 13 tbl.2.

110. HORN & MIRON, *supra* note 39, at 45.

111. MOLNAR ET AL., *supra* note 46, at 15 tbl.4, 16 tbl.5.

For-profits do not have to rely on the kindness of individual donors, but can turn instead to the more tried and true methods of the profit motive and securities markets. It is difficult to say exactly how for-profit schools go about finding investors, or who these investors are, because the great majority of for-profit charter management companies are privately held, and therefore do not file periodic reports with the SEC.<sup>112</sup>

The experience of Edison Schools is perhaps illustrative, if unusually dramatic. During its early stages, Edison Schools raised hundreds of millions of dollars from investors in private transactions (the precise amount is unclear),<sup>113</sup> and notified the SEC that it would attempt to raise about \$150 million in its initial public offering in 1999.<sup>114</sup> The company eventually reached a total market capitalization of more than \$700 million.<sup>115</sup> A private equity firm purchased the company in late 2003 for around \$100 million.<sup>116</sup> There do not appear to be any nonprofit charters that have raised anywhere near as much money as Edison.

Using capital to run large-scale operations makes some for-profit charters competitive with conventional public schools and nonprofit charters. In these cases, the inefficiencies of monitoring and the efficiencies of scale interact to produce an equilibrium between for-profit presence and nonprofit dominance at which the advantages of scale make some parents, governments, and donors indifferent between nonprofit schools offering low monitoring costs and for-profit schools offering high monitoring costs along with the benefits of scale. Since the equilibrium point we observe currently involves only a fourteen percent market share for for-profit schools, we may deduce that the efficiencies of scale in for-profits are small relative to the inefficiencies of high monitoring costs.

We can make this abstract discussion more concrete with a simple example. Imagine a parent whose son wants to play high school football. The parent is contemplating sending her son to a small nonprofit charter high school. If only a handful of boys are interested in playing football, or if the school is unable to afford a football field because it cannot spread the cost sufficiently across its small student body, then the school won't be able to field a team. If the parent's choice is between this nonprofit charter school and a for-profit charter

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112. *Id.* at 5.

113. Arizona State University, Chronology of Edison Project Funding, <http://www.asu.edu/educ/eps/EPRU/documents/edison.html> (last visited Jan. 23, 2006).

114. Edison Sch., Inc., Registration Statement (Form S-1/A), at 2 (Oct. 19, 1999).

115. William C. Symonds, *Industry Outlook 2000, Services: Education*, BUS. WK. ONLINE, Jan. 10, 2000, [http://www.businessweek.com/2000/00\\_02/b3663149.htm](http://www.businessweek.com/2000/00_02/b3663149.htm).

116. Edison Sch., Inc., Transaction Statement (Schedule 13e-3) (Oct. 3, 2003).

school of similar size, she'll send her son to the nonprofit school, because of the risk that the for-profit school will imperceptibly cut quality to benefit shareholders. If, however, the for-profit school enrolls enough students to field a football team and is able to build a field, the parent might rationally run the risk of sending her son to the for-profit school to take advantage of the football team.

As this example demonstrates, there are many potential economies of scale in education, both on the individual school and network levels. Large individual schools experience economies of scale because they can spread fixed costs—such as football fields, administrators, libraries, classrooms, driver's education practice ranges, and cafeteria equipment—across many students. They accomplish this by using these resources intensely. A school with only 30 students, for example, may require access to 5000 library books to cover the full range of subjects necessary for a complete education but will use these books very lightly. A school with 500 students may require the same number of books to cover the same topics, but may use these books much more frequently without seriously diminishing their value to each student. Large schools may also allow more subject specialization among teachers.

Large school networks experience similar economies of scale. For example, they allow managers to centralize decisionmaking, eliminating the need for each school's principal to invest time in becoming fully informed and weighing the options for every decision facing the school. Networks can also centralize data collection, reporting, and accounting, which may become major burdens for small schools. Brown's study observes strong tendencies in for-profit charter networks to centralize these kinds of functions.<sup>117</sup> Additionally, networked schools can centralize purchasing, perhaps obtaining volume discounts from suppliers. Finally, large networks diversify risk and provide additional security for creditors. If one school in the network has a bad year financially, another may have a good year, and one school may be used to secure loans to open another.

There is undoubtedly a tension between the efficiencies gained from scale and the harmful effects of large schools on achievement. Large classrooms or perhaps even large schools arguably hurt achievement.<sup>118</sup> Indeed, one of the more subtle goals of charter policy is to reduce school size. How for-profit schools balance this concern against the advantages of scale is not clear. It appears, however, that the benefits of scale are sufficiently large to create spots for at least a significant minority of for-profit schools.

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117. Brown et al., *supra* note 108, at 1042-44.

118. Valerie E. Lee & Julia B. Smith, *Effects of High School Restructuring and Size on Early Gains in Achievement and Engagement*, 68 SOC. EDUC. 241 (1995).



#### IV. ORGANIZATIONAL FORM AND THE GOALS OF CHARTER SCHOOL POLICY

Besides telling us how charter school operators choose between for-profit and nonprofit forms, agency costs theory can also tell us how charter schools' choice of form affects the schools' abilities to achieve some of the more complicated goals of charter school policy. Charter advocates have cited a wide variety of possible advantages and efficiencies in support of charter schools,<sup>119</sup> including the attraction of additional resources; circumvention of costly regulations and commitments such as union contracts; desegregation; improved opportunities for parents and teachers to participate in school governance; and a variety of benefits that stem from output- rather than input-based accountability (such as efficient input use, satisfaction of parents' preferences for idiosyncratic curricula, and greater experimentation and innovation).

In this Part, I will consider the way that charter schools' choices of organizational form impacts three of these policy goals: resource attraction, parent and teacher participation in governance, and the benefits that stem from output-based accountability. I focus only on these three goals because there is no reason to believe that for-profit and nonprofit charter schools differ meaningfully in their abilities to achieve the other goals I have described. This is true, specifically, with regard to desegregation and circumvention of costly regulations and commitments. Both for-profit and nonprofit forms have advantages, and whether a state should favor for-profits or nonprofits may depend at least partly on the state's needs. In most states, nonprofits probably better serve the complex ends of charter school policy.

##### A. Resource Attraction

One goal of charter policy is to attract resources that otherwise may never enter the public education system. Nonprofits and for-profits differ significantly in the types of additional resources they attract. For-profits tend to attract private capital and investment.<sup>120</sup> Unlike nonprofit schools and conventional public schools, for-profits are capable of going into private securities markets to offer equity shares in schools. For-profit schools may also be capable of obtaining innovative forms of debt financing that nonprofit and

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119. See, e.g., Amy Stuart Wells et al., *Underlying Policy Assumptions of Charter School Reform: The Multiple Meanings of a Movement*, 100 TEACHERS C. REC. 513 (1999).

120. See *supra* notes 112-116.

conventional public schools cannot obtain. Nonprofit schools, in contrast, attract donations. As noted above, these donations may come in the forms of volunteer labor, undercompensated employee labor, or cash.<sup>121</sup>

On balance, policymakers will find the resources attracted by nonprofit schools most helpful. There may be instances in which private for-profit firms' capital-raising abilities may be useful. If for some reason a district is short of capital—enrollment is growing rapidly, for example, or the district cannot get voter approval for its bond initiative—the possibility of authorizing hybrid charter schools to build new schools with private financing may be attractive.<sup>122</sup> But these instances are rare. Many conventional public school districts have good credit and can obtain funds through low-cost or even tax-preferred bonds. Authorizing for-profit charter schools to issue securities at rates that reflect inferior tax status and the risks associated with an immature industry seems a rather roundabout way of dealing with capital shortages. On balance, therefore, nonprofit schools probably attract more useful resources to public education than for-profit and hybrid schools do.

### *B. Localized Governance*

Many charter school advocates have argued for charter schools as an antidote to large-scale operations and as a way of empowering local teachers and parents to become involved in school governance.<sup>123</sup> In spite of their efficiency in reducing costs, large schools and large networks of schools have been said to cause a variety of ills. Large schools may alienate and disorient students, and large, centralized networks may remove authority for crucial decisions like curriculum design from those best positioned to make them. Centralized governance may also discourage parents from participating and volunteering in their schools. Some charter advocates have argued that charter schools may be a solution to this problem if they can reduce school size and encourage parents and teachers to reengage in the governance of their schools. For-profit charters clearly are not as effective as nonprofit charters at achieving this goal. As noted above, for-profit schools' most viable business model is to

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121. See *supra* Subsection II.B.3.

122. I am grateful to Fadi Hanna for this point.

123. See Brown et al., *supra* note 108, at 1035-38 (citing research critical of large schools and discussing support for charter schools as a method of reducing school size and increasing parent and teacher participation in governance); see also RAY BUDDÉ, EDUCATION BY CHARTER: RESTRUCTURING SCHOOL DISTRICTS (1988) (offering one of the earliest arguments for charter schools on the ground that decentralized governance structures would foster innovation and enthusiasm among teachers and parents).

operate larger networks and larger individual schools than nonprofits do and to centralize decisionmaking. Even for-profit charters, however, tend to run smaller individual schools than conventional public schools.<sup>124</sup>

### C. Output-Based Accountability

Many charter school theorists have pointed to a variety of benefits that may derive from charter schools' accountability for outputs rather than inputs. The value created by output-based accountability may take a variety of forms. For example, market pressure may push charter schools to satisfy idiosyncratic parent and student preferences for particular novel curricula. The National Study of Charter Schools found that "the primary reason for founding charters was to realize an alternative vision for schooling."<sup>125</sup> These idiosyncratic curricula improve efficiency by allowing parents and students who prefer these curricula over more traditional methods to derive more satisfaction from the same level of government spending. Even if distinctive curricula do not improve students' performance on standardized tests, they make parents and students happier and more satisfied with schools.

Another possible benefit is the incentive introduced by market competition to use inputs efficiently. Milton Friedman provided the first forceful articulation of these benefits in 1955,<sup>126</sup> and numerous other proponents of school choice have since made similar arguments.<sup>127</sup> John Chubb and Terry Moe argue that choice forces inefficient schools to close and allows efficient schools to thrive through "natural selection."<sup>128</sup> Before the No Child Left Behind Act (and perhaps even now) conventional public schools may have had inadequate incentives to hire capable teachers, for example, because the

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124. MOLNAR ET AL., *supra* note 46, at 18 tbl.7.

125. OFFICE OF EDUC. RESEARCH & IMPROVEMENT, U.S. DEP'T. OF EDUC., NATIONAL STUDY OF CHARTER SCHOOLS, FOURTH-YEAR REPORT: THE STATE OF CHARTER SCHOOLS 2000, at 42 (2000) (noting that seventy-five percent of charter schools cited "vision" as one reason for opening); UTAH FOUND., *supra* note 19, at 2 (detailing a wide variety of curricula among Utah's charter schools); Hess & Maranto, *supra* note 82, at 64 (finding that in Arizona, "[c]harter operators are relatively unconstrained in determining their curricula, and there is much variation among schools").

126. Milton Friedman, *The Role of Government in Education*, in *ECONOMICS AND THE PUBLIC INTEREST* 123 (Robert A. Solo ed., 1955); *see also* FRIEDMAN, *supra* note 6, at 85-107.

127. *See, e.g.*, Jonathan B. Cleveland, *School Choice: American Elementary and Secondary Education Enter the "Adapt or Die" Environment of a Competitive Marketplace*, 29 J. MARSHALL L. REV. 75, 129-30 (1995); Robert Maranto, *The Death of One Best Way: Charter Schools as Reinventing Government*, in *SCHOOL CHOICE IN THE REAL WORLD*, *supra* note 66, at 39, 39.

128. CHUBB & MOE, *supra* note 6, at 32-33.

negative consequences may not have been significant (at least in a market-accountability sense). Ideally, market competition and the threat of charter school closure forces more efficient input use by charter schools.

Output-based accountability may also allow charter schools to innovate more efficiently than conventional public schools. Besides producing value by catering to idiosyncratic preferences,<sup>129</sup> charter schools may produce value by creating gains on widely agreed upon standard measures of success because charters have both the regulatory freedom and the incentive to innovate.<sup>130</sup> Though some early charter school theorists argued that regulatory freedom alone could produce innovation and experimentation,<sup>131</sup> many theorists since have rooted these arguments in the pressures that output-based accountability produces. In Chubb and Moe's account of the benefits of charter schools, for example, regulatory freedom improves charter schools' ability to innovate and discover more efficient methods primarily because regulatory freedom makes schools more responsive to market pressures.<sup>132</sup> They argue that only schools "unconstrained by bureaucracy" can change quickly enough to meet parents' and students' preferences.<sup>133</sup>

All of this is worth thinking about because there is reason to believe that for-profit schools are slightly more responsive than nonprofit schools to the pressures of output-based accountability. Many early nonprofit theorists argued that in the absence of a profit motive and monitoring by interested shareholders, nonprofits would be less responsive to market pressures. If these theoretical predictions are true, policymakers may want to encourage for-profit schools, rather than nonprofit schools, to take advantage of the myriad benefits of output-based accountability.

These theoretical predictions favoring for-profits' responsiveness to output-based pressures have not been strongly supported by empirical research, however. In the last twenty years, the relative efficiency of for-profit and nonprofit firms in responding to market pressures has been the subject of an extensive empirical debate, much of it focusing on the healthcare industry. Although some research has suggested that nonprofit firms are less likely than for-profit firms to structure managers' pay in ways that directly incentivize

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129. See *supra* note 125 and accompanying text.

130. See, e.g., BUDE, *supra* note 123 (arguing that charters should be granted only to groups of teachers within districts and that the primary benefit of charter schools would be the development of new educational techniques).

131. *Id.*

132. CHUBB & MOE, *supra* note 6, at 36-37.

133. *Id.* at 37.

efficient behavior,<sup>134</sup> and other studies have found a positive correlation between for-profit organizational form and efficient input use,<sup>135</sup> this body of research is ultimately inconclusive.<sup>136</sup>

## V. REGULATORY IMPLICATIONS

Charter school theorists, as well as many state legislatures and charter regulators, have failed to recognize the important role that organizational form plays in charter schools. Although most states prohibit for-profit organizations from directly holding charters, only a handful of states acknowledge that the means for circumventing this restriction—hybrid contracting arrangements—are simple and widely used.<sup>137</sup> Charter school regulators are also seemingly unaware of the importance the nonprofit role has played in ensuring charter schools' success. Most charter school regulation emphasizes direct bureaucratic and parental monitoring, even though the nonprofit form may have done as much or more than these forms of monitoring to ensure charter schools' efficiency. Additionally, charter school research has inadequately explored the consequences of organizational form for some of the more complex goals of charter school policy. Though regulators and researchers may have been aware that for-profit schools presented some risk for abuse, there has been no serious attempt to assess the impact of organizational form on goals such as resource

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134. A recent study of hospital manager compensation found that even when it is possible to incentivize managers to achieve, nonprofit firms are less likely than for-profit firms to do it. Roomkin & Weisbrod, *supra* note 101, at 750-51. Output-measurement problems may make writing incentive contracts in nonprofit firms difficult. Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991).

135. See, e.g., John L. Fizek & Thomas S. Nunnikhoven, *Technical Efficiency of For-Profit and Non-Profit Nursing Homes*, 13 MANAGERIAL & DECISION ECON. 429 (1992).

136. For a thorough survey of research comparing for-profit and nonprofit hospital performance, see Pauline Vaillancourt Rosenau & Stephen H. Linder, *Two Decades of Research Comparing For-Profit and Nonprofit Health Provider Performance in the United States*, 84 SOC. SCI. Q. 219 (2003). Rosenau and Linder said that a majority of empirical studies of hospitals between 1980 and 2003 found that nonprofit providers performed better on measures of cost. *Id.* at 224. For specific empirical studies that have criticized the argument that for-profit hospitals use inputs more efficiently than nonprofit hospitals, see, for example, Tami L. Mark, *Psychiatric Hospital Ownership and Performance: Do Nonprofit Organizations Offer Advantages in Markets Characterized by Asymmetric Information?*, 31 J. HUM. RESOURCES 631 (1995); and H. Naci Mocan, *Cost Functions, Efficiency, and Quality in Day Care Centers*, 32 J. HUM. RESOURCES 861 (1997), which makes inconclusive findings about the relative efficiency of for-profit and nonprofit daycare providers.

137. Fischer, *supra* note 33.

attraction, localized governance, and responsiveness to output-based competition.

A number of policy reforms would make charter school regulation more responsive to the problems and opportunities posed by for-profit and nonprofit forms. First, while almost all state legislatures have already prohibited for-profit schools from directly holding charters, those states that have not should do so. Furthermore, legislators and agencies should close the loopholes that allow for-profit entities to operate charter schools by signing management contracts with nonprofit charter-holding entities. Most state legislatures, by prohibiting for-profit entities from holding charters directly, have made a judgment that for-profit charter schools are bad policy. My analysis suggests that this judgment is sound except in a limited set of circumstances. State legislatures should take their own judgment seriously by prohibiting for-profit entities from functionally achieving charter ownership through artful paper shuffling.

There is no reason to distinguish between direct for-profit ownership and hybrid arrangements that functionally emulate for-profit ownership. The nonprofit entities that contract with for-profit management firms in hybrid schools are unlikely to meaningfully check the for-profit firms' tendency to exploit high monitoring costs. The nonprofit boards in hybrid schools are often controlled by the for-profit management firms. And even if the nonprofit boards begin by bargaining at arm's length, they inevitably come to occupy extremely weak bargaining positions after the for-profit management firms completely take over their schools. In such instances, ending the contractual relationship means shutting down the school entirely.

Even if the majority of state legislatures are wrong and for-profit schools are actually good public policy, hybrid arrangements are still suboptimal. If for-profit schools are desirable, why force them to jump through the hoop of hybrid management structures? If state legislators seriously believe that for-profit schools make sense, the solution is not hybrid structures, it is direct for-profit ownership.

A prohibition on hybrid and nominally for-profit charter schools should perhaps be tempered by a couple of exceptions. There might be an exception for instances in which the for-profit firms are being used to remedy capital shortages in public schools. Such an exception would be difficult to craft. It might require, for example, a for-profit school's application to be sponsored by a conventional public school district, or a public school district to prove to the chartering agency that the district is facing some capital crisis for which empowering a for-profit school is the best solution. The prohibition on hybrid and nominally for-profit charter schools could also create an exception for hybrid arrangements that grant for-profit companies only a small role in the

management of schools. Such an exception might prohibit any contract between a nonprofit charter-holding entity and a for-profit firm that grants more than a certain percentage of the school's annual revenue to the for-profit firm for management services.

Second, if state legislatures refuse for whatever reason to prohibit nominal and functional for-profit control of charter schools, then state legislatures or administrative agencies should place indirect limits on management firms' ability to cut costs and increase profits. Charter regulators already monitor charter school finances relatively vigorously. These regulators could also use their administrative lawmaking authority to fashion and enforce rules limiting the profits that even for-profit management firms can make. Alternatively, agencies might mandate certain inputs—such as teacher or curriculum certification—or limit the amount of money that for-profit schools may spend for purposes other than the procurement of inputs to be used on a school's premises or at centralized administrative offices. These kinds of regulations cannot reproduce the culture of nonprofit organizations that Hansmann and others have identified as being important to nonprofits' effectiveness. But they may curb the most egregious attempts to cut quality in ways that parents and governments cannot observe directly.

Third, legislators and regulators should, to the extent possible, close the loopholes in existing monitoring regimes. Some of the failures of charter school monitoring are inevitable. Tests, for example, are always limited and they will always imperfectly match the highly complex goals of education. But many of the monitoring failures that have produced nonprofit dominance are the results of flaws in charter policy design and implementation, rather than inevitable obstacles that can never be overcome. For instance, policymakers should ensure that charter-monitoring agencies have adequate staff and resources to gather whatever information is available and disseminate it to the public. These agencies can consistently gather test data, financial data, and enrollment figures, and can make these data available to the public, thereby helping parents more effectively monitor charter schools themselves.

Finally, enforcement authority must be clearly delineated. Everyone—regulators, operators, and parents—should clearly understand which agency can force accountability and on what terms. Because closing a charter school often requires agencies to overcome significant public opposition, rules regarding achievement should be stringent, clear, and permit little opportunity for dispute.

**CONCLUSION**

My goal in this Note is not to defend charter policy against some set of criticisms or to argue that charter schools should be enabled, funded liberally, or otherwise encouraged. Whatever benefits charter schools may produce must be weighed against a substantial set of costs, none of which I explore here. My argument is simply that agency costs theory illuminates a number of interesting questions and problems in charter school regulation, some of which legislators would be wise to address.

This Note makes three main points. The first is descriptive: Nonprofits have come to dominate the charter school industry because they mitigate the agency costs that stem from parents' and governments' inability to monitor charter schools effectively and to hold them accountable. Nonprofit schools are able to perform this function because (1) legal restraints on profit distribution reduce the schools' ability to exploit parents and governments' inability to monitor, and (2) nonprofit charter schools tend to attract capable administrators and teachers personally devoted to charter schools' missions. For-profit firms maintain a substantial presence, however, because they can raise capital more efficiently than nonprofit firms can. Sometimes the efficiencies of running large-scale operations with this capital outweigh the inefficiencies of high monitoring and agency costs.

The second point is also descriptive: Nonprofits may be slightly better than for-profit schools at achieving some of charter school policy's more complex goals. In particular, nonprofits may attract more valuable resources and improve teacher and parent participation in governance.

The final point is prescriptive: Charter school regulation must more tightly control for-profits. For most of the charter school movement's history, the nonprofit form has compensated to a large extent for the limits of the more direct forms of accountability that tend to consume policymakers' and researchers' attention. Given the substantial number of for-profit charter schools, regulators should limit hybrid for-profit-nonprofit arrangements, curb for-profits' ability to cut quality in imperceptible ways, strengthen existing bureaucratic monitoring regimes, and more clearly allocate authority to enforce accountability. Organizational form has played an important role in shaping America's charter schools. Policymakers would be wise to take it more seriously.





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