PRIVATE ENTERPRISE
IN AMERICAN EDUCATION

AMERICAN ENTERPRISE INSTITUTE

SPECIAL REPORT 1

Beyond Good and Evil

Understanding the Role of For-Profits in Education through the Theories of Disruptive Innovation

Michael B. Horn | April 2011

Foreword

For decades, for-profit educational provision has been tolerated, often grudgingly. In the world of charter schooling, for-profit providers are lambasted and sometimes prohibited. In higher education, for-profit institutions have grown rapidly, enrolling millions of nontraditional students and earning enmity, suspicion, and now investigative and regulatory actions in Washington. When it comes to student lending, teacher quality, and school turnarounds, there is a profound preference for nonprofit or public alternatives. All of this is too familiar to be remarkable.

The problem is that K–12 and higher education desperately need the innovative thinking and nimble adaptation that for-profits can provide in the presence of healthy markets and well-designed incentives. As critics have noted, for-profits do indeed have incentives to cut corners, aggressively pursue customers, and seek profits. But these traits are the flip side of valuable characteristics—the inclination to grow rapidly, readily tap capital and talent, maximize cost-effectiveness, and accommodate customer needs. Alongside nonprofit and public providers, for-profits have a crucial role to play in meeting America's twenty-first-century educational challenges cost-effectively and at scale.

However, we rarely address for-profit provision in this fashion. Most statutory and regulatory discussion focuses on how to rein in for-profit providers. There is little discussion of what it would take to harness the potential of such providers, while erecting the incentives and accountability measures that can ensure a level, dynamic, and performance-oriented playing field.

AEI's new *Private Enterprise in American Education* series is designed to pivot away from the tendency to reflexively demonize or celebrate for-profits and instead understand what it takes for for-profits to promote quality and cost-effectiveness at scale. In the first installment of the series, Michael B. Horn of the Innosight Institute explains why policymakers and reformers who castigate for-profits or nonprofits as inherently bad or good are mistaken. It is not about whether for-profits are "bad" or "good," Horn cautions, but about what for-profits are and are not given incentives to do regarding consumer satisfaction, embedded regulatory structures, and shareholder demands. As Horn argues, "Government should not discriminate between for-profits and nonprofits as a matter of blanket policy. Instead, it should ask if the company with which it is contracting, for-profit or nonprofit, is delivering on what society is paying it to do, as determined by both the spirit and letter of the law. And policymakers more broadly should be asking if the law is asking these organizations to do the right thing."

Given tight budgets and the heated debates over gainful employment, the role private enterprise can and should play in American education needs to be brought to the forefront of reform discussions. I am confident you will find Horn's piece as eye opening and informative as I have. For further information on the paper, Michael Horn can be reached at mhorn@innosightinstitute.org. For other AEI working papers, please visit www.aei.org/futureofeducation. For additional information on the activities of AEI's education policy program, please visit www.aei.org/hess or contact Jenna Schuette at jenna.schuette@aei.org.

—FREDERICK M. HESS
Director of Education Policy Studies
American Enterprise Institute

Executive Summary

The role of for-profit companies in public education—education financed by the government—has attracted increased scrutiny over the past few years. Though for-profit entities such as textbook companies have had contracts with public school districts for decades, recent controversy over what government officials and others perceive as low graduation rates and questionable marketing practices within the for-profit higher-education space has drawn significant negative attention. As this controversy heats up, it is prompting a wider debate about the role of for-profit companies in education—a debate too often characterized by faulty assumptions and misunderstandings on both sides.

Many in public education assume the worst about for-profit corporations, arguing that they are money-grabbing entities that will shortchange the public good if it means increased profits. Critics see no place for for-profit providers in American education. Supporters view for-profits as a force for good that can harness the profit motive to attract top talent and scale quality in public education. The government often perpetuates these divides by drawing lines in the sand of what activities companies can and cannot do based on their corporate structures. Despite these views on for-profits, however, the reality is different. Policymakers, officials, providers, and other members of the debate would do well to keep three key points in mind:

First, for-profit companies are not inherently good or evil. Rather, these companies do what their customers offer incentives to do—not much more or less. To say that for-profits are evil or poor quality misses the point because quality is defined by what a customer will pay someone to do. In the case of higher education, for example, government policies have historically defined the job to be done as expanding access—and have tied government dollars to this explicit goal. For-profit institutions, then, should not be faulted for focusing on access. The government and society have offered incentives for this behavior. Blaming for-profits for doing what we have asked and paid them to do from the outset makes little sense.

Second, there are far fewer inherent and predetermined differences between for-profit companies and their nonprofit counterparts than many assume. Both for-profits and nonprofits have business models, and there are many examples of corrupt nonprofits. Whether a company is a for-profit or nonprofit does not, in and of itself, mean that it will or will not be corrupt. Categorizing the world as one of for-profits versus nonprofits distracts from what the real question should be: are companies, regardless of corporate structure, delivering on what society is paying them to do, as specified in the law? Even more broadly, is the law asking them to do the right thing?

Third, the biggest inherent differences between for-profits and nonprofits stem from their fundamental corporate structures, which determine what they do with their profits—and thus affect their ability to attract capital and scale—as well as what opportunities look attractive. Specifically, for-profit corporations have owners or shareholders; nonprofit corporations do not. This means that for-profit corporations do not reinvest all their profits into their core business as do successful nonprofits, but this is not a bad thing. Returning money to their owners provides a natural pathway for for-profits to attract even more capital to grow and scale operations and attract more top talent when there is a viable market. Nonprofits do not share this natural pathway. Conversely, not having shareholders allows nonprofits to play a critical role and remain invested in a sector even in the absence of a viable market—a circumstance from which successful for-profits retreat, as they will not be able to provide meaningful returns for their owners.

Ultimately, the government and education stakeholders should not discriminate between for-profits and nonprofits. Policies and purchasing should instead focus on and define the desired outcomes from government spending without specifying the processes or inputs used to achieve those outcomes. They should also reward those entities—regardless of corporate structure—that do the best at achieving the outcomes for the best price relative to the competition and, in cases like education where the purpose is to serve an end user in addition to society, align those outcomes with what the end user actually needs. Moving beyond the tired debates of for-profit versus nonprofit can result in a much healthier debate over the end goal of policy. Although for-profits are not a panacea for what ails society, using what they do well in conjunction with policy that rewards the right outcomes—and is open to an honest debate about what those should be—just might start to move us closer to those elusive solutions that could greatly benefit society.

PRIVATE ENTERPRISE IN AMERICAN EDUCATION

Beyond Good and Evil

Understanding the Role of For-Profits in Education through the Theories of Disruptive Innovation

By Michael B. Horn

Introduction

The role of for-profit companies in public education—education financed by the government—has attracted increased scrutiny over the past few years. On one hand, for-profit entities such as textbook companies have had contractual agreements with public schools for decades that have received scant attention. On the other hand, several for-profit universities have attracted significant negative attention of late for what some government officials and others perceive as low graduation rates and questionable marketing practices for recruiting students. As this controversy heats up, it is prompting a wider debate about the role of for-profit companies in education, which has been fueled by the emergence of new for-profit K–12 education companies along with increased interest in education from private capital sources, including News Corporation, venture capitalists, and private equity firms.

Many in public education assume the worst when it comes to for-profit corporations. One oft-repeated assumption is that for-profit companies are money-grabbing entities that will shortchange the public good. Some critics see profiting from public funds designed to serve children as an evil to be rooted out of the system.

Others—seemingly fewer in number in public education circles—view for-profit corporations as a force for good that can harness the profit motive to attract top talent and scale quality in public education. Many in this group see nonprofit and government organizations as inherently bloated—and consequently slow to scale and quick to waste public funds—and view for-profits as a needed counterbalance that can drive efficiencies.

These depictions have taken on lives of their own in public education circles. The government often perpetuates these divides by drawing lines in the sand of what activities companies can and cannot do based on their corporate structures. Recently, for example, regulations prohibited for-profit companies from applying directly to the Department of Education's Investing in Innovation (I3) program. Despite the two extreme views on for-profits, however, the reality is different.

First, for-profit companies are not inherently good or evil. Some corrupt for-profits flagrantly violate the law, but many others accomplish remarkable things. Likewise, some for-profit companies are wildly successful and others are wildly unsuccessful. Successful for-profits solve the problem or do the job that customers—the entity or person paying for the product or service—hire them to do. Over time they improve, grow, and serve more demanding customers with more demanding products—and consequently return increasing value to their shareholders. When there is a viable, publicly financed market opportunity in front of them, successful for-profit corporations respond by chasing the customer's—in this case, the government's—dollars by doing what it asks them to do, much of which is codified in policies and regulations. As a result, as they build their business, successful for-profit companies will do what regulations offer incentives to do—not much more and not much less. If there are "smart" regulations and policies in place that cause the government customer to make "smart" purchasing decisions, for-profit companies will do "good" things. If there are "stupid" ones in place, they will do "bad" things. Unsuccessful for-profits are those that receive plenty of investment up front on the promise of success but do not ultimately satisfy the customer and therefore do not gain traction in the marketplace. Trying to deliver products or services that the company perceives to be of moral value will not have an impact if customers do not value them as well.

Second, there are far fewer inherent and predetermined differences between for-profit companies and their nonprofit counterparts than many assume. Much of the debate over whether for-profits or nonprofits are more or less virtuous is a red herring to what the real questions should be. For the government paying, the question should be, "Is this given company, regardless of corporate structure, delivering

Michael B. Horn (mhorn@innosightinstitute.org) is the cofounder of the Innosight Institute, where he is the executive director of education.

on what society is paying it to do, as specified in the law?" And more importantly, the government should ask, "Is the law asking this entity to do the right thing?" As mentioned above, there are corrupt for-profits, but there are also corrupt nonprofits (recall the United Way scandal several decades ago). Furthermore, both for-profit and nonprofit corporations must bring in revenue to sustain their operations. Contrary to the name, the most successful nonprofits (called nongovernmental organizations, or NGOs, abroad), like their for-profit counterparts, do make a "profit," as they bring in more revenue than they spend, which they then reinvest in their business to serve more people and improve their offerings. When the government is the customer, both for-profits and nonprofits may or may not be aligned with the needs of their targeted end user, as the end user is often not the one paying. That all depends on how well the government's policies—which dictate what products or services will receive payment—align to the end users' actual needs, as opposed to their perceived ones. The notion that for-profits are inherently motivated to cut costs at the expense of doing their job—or that nonprofits inherently have less discipline in controlling costs and therefore are far less streamlined and efficient—has proved largely to be a smokescreen in public education to this point.

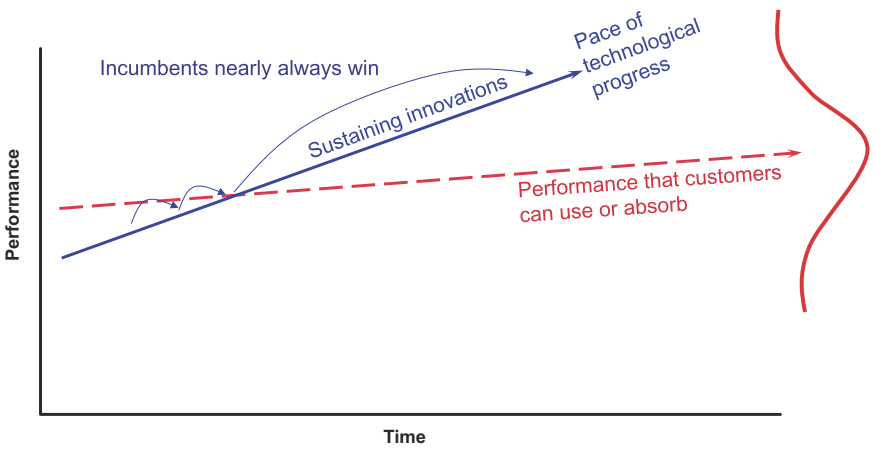
Third, the biggest inherent differences between for-profits and nonprofits stem from their fundamental corporate structures, which determine what they do with their profits—and thus affect their ability to attract capital and scale—as well as what opportunities look attractive. Of course, for-profits and nonprofits are regulated in different ways. For-profits pay corporate taxes, for example, and nonprofits do not. But this is not their most salient difference and, in theory, could change at any point. They do have fundamentally different corporate structures, however. For-profit corporations have owners or shareholders; nonprofit corporations do not. Having owners means, first, that for-profits will not reinvest all their profits into their core business, as successful nonprofits will, but instead will return some of those profits to the owners. This is not necessarily a bad thing, however, as many assume, as the second implication is that because for-profits return money to their owners, for-profits naturally attract even more capital to grow and scale operations and attract more top talent when there is a viable market. Nonprofits do not share this natural tendency. As a result, if they are performing a valuable service that society considers "good," then for-profits have a more natural ability to scale a solution. This means that successful for-profits tend to be crystal clear about their end objective: make increasing profits by doing the job their best customers pay them to do. Nonprofits lack this easy metric, which makes it relatively harder for them to focus. This focus and ability to scale can be critical tools in a policymaker's arsenal. Bad policies that reward the wrong things can also be a significant risk. Nonprofits play a vital role because without shareholders, they can remain invested in a sector even in the absence of a viable market—a circumstance from which for-profits retreat, as they will not be able to provide meaningful returns for their owners.

The government should employ both for-profits and nonprofits to serve the public good. Legislation that creates artificial roadblocks by favoring one over the other does not advance the public good and may even shortchange it.

These conclusions raise important considerations for policymakers and society. First, the government should employ both for-profits and nonprofits to serve the public good. Legislation that creates artificial roadblocks by favoring one over the other—although sometimes useful for political sloganeering—does not advance the public good and may even shortchange it. Given the ability of for-profits to scale a solution by attracting increased capital in addition to government funding, there is significant pressure on the government to craft policy conditions that will capitalize on for-profits' incentives for growth and profit when there is a viable, publicly financed market opportunity. Critically, for-profits and nonprofits alike will only move the needle if the government customer demands continual improvement. Policies should therefore focus on and define the desired outcomes without specifying the processes or inputs used to achieve them. They should also reward organizations that achieve the best outcomes for the best price relative to the competition and, in cases like education where the purpose is to serve an end user—such as a student—in addition to society, align those outcomes with what the end user actually needs.

This paper analyzes these conclusions about the similarities between for-profits and nonprofits, the unique advantages of for-profits and nonprofits, and their policy implications through the theories of disruptive innovation. These theories have been applied in a variety of contexts, from the for-profit to the nonprofit and government worlds and from highly regulated industries to deregulated ones, to help make innovation—historically an unpredictable and chaotic process—far more predictable and successful. By approaching these issues this way, this paper presents an opportunity for fresh thinking on the role of for-profits in public education.

FIGURE 1
TRAJECTORY OF SUSTAINING INNOVATION



SOURCE: © Innosight Institute

What Is a Successful For-Profit Company Motivated to Do?

To move beyond the overly simplistic question of whether for-profits are inherently good or evil, it helps first to understand how a successful company functions—what incentives it responds to, as well as what it does and does not do. The theory of disruptive innovation (see figure 1) sheds light on this, as it answers the fundamental question: "Why do successful organizations ultimately fail?"

In figure 1, the vertical axis measures the quality of the product or service, and the horizontal axis charts this performance over time. In every market, there are two trajectories of performance. The first, represented by the dotted line, reflects what the average customer is able to use. As the figure suggests, customers' needs tend to be relatively stable over time. The second trajectory, represented by the solid line, is the pace of technological progress. This shows that technological progress almost always outstrips customers' ability to use the improvements. This means that a technology that is not good enough to meet customers' needs at a certain time (the left side of the figure) is likely to improve and eventually overshoot what customers can use.

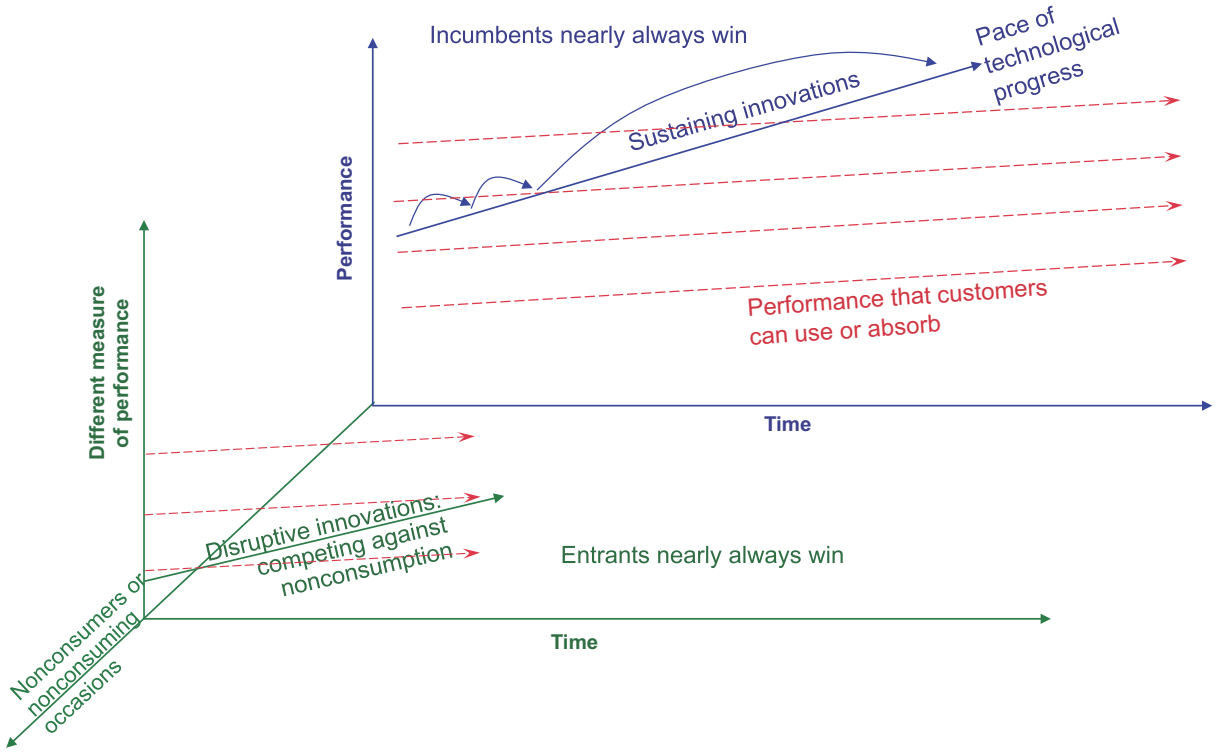
Some of the innovations that improve product performance are incremental ones; others are dramatic breakthroughs. But both are called sustaining innovations so long as their purpose is the same—to help companies sustain their movement upward along the trajectory of performance improvement to make better products that can be sold for better profits to their best customers. Research shows that companies that lead their industries on the left side of this figure, before the battles of sustaining innovation begin, are almost invariably still the leaders in their industries when these battles are over.[1] It does not matter how technologically difficult the innovations are. The leading companies in the industry invariably find a way to get it done because their motivation to do so is high.

For example, recall the early personal computers from the 1980s. Powered by Intel's 286 microprocessor, the machines could barely run a basic word-processing program. But true to form, Intel improved the microprocessor year after year and retained its market dominance, as the company was consistently motivated to implement features that would allow it to sell better products for better profits to its best customers. The same phenomenon has held true in many other industries, from steelmaking to airlines.

Equally important for this discussion, if implementing a new feature, improvement, or innovation would *not* help a company sell better products for better profits to its best customers, that firm is *not* motivated to do it. We see this most clearly when looking at another kind of innovation, which has historically proved almost impossible for the industry leaders to catch. We call this a disruptive innovation.

A disruptive innovation is not a radical, breakthrough improvement along the existing trajectory in figure 1.

FIGURE 2
THE THEORY OF DISRUPTIVE INNOVATION



SOURCE: © Innosight Institute

Instead of sustaining the leading companies' place in the original market, it disrupts that trajectory by offering a product or service that is *not as good* as what companies are already selling, as judged by the traditional measures of quality and performance. Because the innovation is not as good as the existing product or service, the customers in the original market cannot use it. Instead, the disruptive innovation extends its benefits to people who, because of a lack of skills, money, or access, are unable to consume the original product—so-called nonconsumers (shown in the new plane in figure 2). Disruptive innovations tend to be simpler, more affordable, and more decentralized or more convenient than existing products. This allows them to take root in simple, undemanding applications in a new market. Here, what constitutes quality, and therefore an improvement, is different from the quality and improvement in the original market.

Little by little, the disruptive innovation improves. At some point it becomes good enough to handle more complicated problems, and customers from the back plane rapidly adopt it, as they are delighted with this simpler, more affordable, and more convenient product. Over time, therefore, a disruptive innovation replaces the original product or service—which is relatively complicated, expensive, inconvenient, and centralized—with a product that is more affordable, simple, convenient, and accessible. This process has transformed countless sectors—from computing, where personal computers disrupted mainframe and minicomputers, to accounting, where many now use TurboTax instead of accountants for their taxes. It is also currently happening in postsecondary education, where online universities are disrupting traditional universities by making education far more convenient.

Because the definition of performance is so different in the front plane compared to the back plane, and the industry leaders' customers cannot use the disruptive product initially, the leading companies have difficulty implementing disruptive innovations. When the leading companies on the sustaining-innovations trajectory are faced with the choice of making better products that yield better profit margins for their existing customers

versus making lower-priced, simpler products that yield slimmer margins for people who are not their best customers, they invariably find it more attractive to build and offer more and better. In other words, they respond to incentives by doing what their best customers pay them to do so they can make more money. As a result, new companies almost invariably enter and grow to dominate the industry by introducing or competing with disruptive innovations. This is why Digital Equipment Corporation, a leader in the manufacturing of minicomputers, was disrupted by the personal-computer industry, and why the Detroit automakers were unable to fend off the upstart Japanese automakers.

Disruptive innovations tend to be simpler, more affordable, and more decentralized or more convenient than existing products.

This insight is important to understand when evaluating the track record of for-profit universities—and for-profits more generally. Companies do what their customers offer incentives to do—not much more or less. The United States' dominant higher-education policies have focused on expanding access for more than half a century—allowing more students to afford higher education regardless of true cost—through mechanisms such as Pell Grants and other financial aid programs, subsidies, and access to low-interest student loans. As a result, the government has, in essence, been the true customer for a significant portion of higher education.[2] Although regulations such as those requiring gainful employment set a minimum bar for not burdening students with too much debt, they have been just that—a low bar. Because the federal government historically has had all-or-nothing access to its funds as opposed to a sliding scale where an institution's performance determines how much of its operations it can finance through government funds, it cannot set the bar too high lest it roll back its chief priority. Its policies have not focused on lowering higher-education costs or on graduating more people per se. Instead, the government pays money for enrolling students. True to form, the for-profit universities have followed suit and done what the customer—the government—has given them incentives to do: expand access.

For-profit universities have seized hold of online learning to capitalize on these incentives even more successfully—only now many in society are questioning whether the incentives focus on the wrong thing by ignoring graduation rates and the debt levels students face when they graduate. To say that for-profits—or any organization fulfilling this set of policies—are evil or poor quality misses the point. Quality is defined by what a customer is paying someone to do, and in this case, for-profits are doing a spectacular job of expanding access. The stories of low graduation rates and students facing high debt with limited prospects to repay it are predictable, as government policies do not go beyond expanded access in defining the job to be done and how the government will pay for it. This is not the fault of the for-profit institutions, however, but of the government and society, which has offered incentives for this behavior. Blaming for-profits for doing what we have asked and paid them to do from the outset makes little sense.

How Easy Is It to Change the Policies?

A natural question arises from this analysis. Once society (or a segment of it) recognizes the problem—that it is not paying for the job it actually wants done—is the fix as simple as changing the regulations so the companies will change their actions to meet demand? Unfortunately, no. Policymakers need to get the regulations right early or they will have a struggle ahead, unless disruptive innovators emerge that can transform the sector.

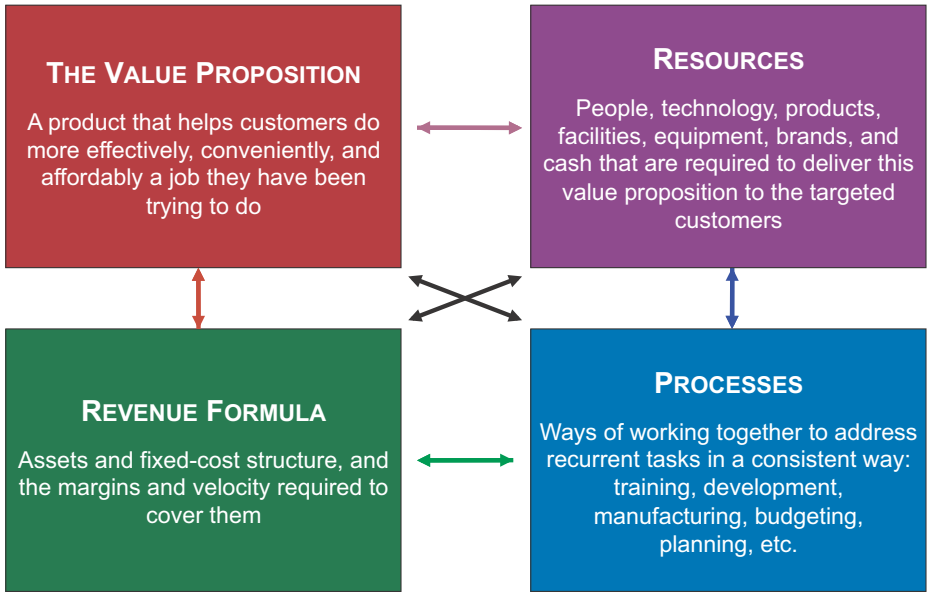
To explain this, we first need to understand what a business model is and how it locks a system into place. Business models are comprised of four interdependent elements, as depicted in figure 3. They start with a value proposition: a product or service that helps users do a job they have been trying to do more effectively, conveniently, and affordably. To deliver that value proposition, the organization must assemble the required set of resources—such as people, products, technologies, equipment, and facilities.

As the organization repeatedly uses its resources to deliver its value proposition, processes—habitual ways of getting recurrent things done—coalesce that are both explicit and, even more often, implicit. This is where an organization's culture resides. As Edgar Schein, one of the world's foremost scholars of organizational culture, wrote, culture is "a pattern of basic assumptions—invented, discovered, or developed by a given group as it learns to cope with its problems of external adaptation and internal

integration—that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems."[3]

When an organization's capabilities reside primarily in its people, change is relatively simple to manage because those who are not willing to change can be fired as needed. But when the capabilities reside in its processes—or its culture—change is extraordinarily difficult because processes designed for certain tasks usually perform efficiently, but the same process employed for a different task often seems bureaucratic. In other words, a process that is a *capability* in executing a certain task can be a *disability* in executing other tasks. Think of trying to follow the same precise steps for building two different Lego designs. Processes by their very nature are meant *not* to change. They are established to help employees perform recurrent tasks in a consistent way, time after time, without needing intense managerial monitoring.[4]

FIGURE 3
THE ELEMENTS OF A BUSINESS MODEL



As the organization follows its processes to deliver the value proposition, a profit—or revenue—formula emerges. The profit formula defines how large the organization must be to break even and what kind of profit it must bring in to cover the cost of its resources. The profit formula in turn determines the kinds of value propositions the business model can and cannot offer.[5] These four elements of the business model quickly become interdependently locked.[6] In education, for example, textbook companies make money from selling large volumes per title. Even though many within those companies would love to offer more targeted products for specific groups of learners, books that promise only short print runs or modular pieces of content intended for small niches do not make sense within their business model, as this would hurt their profitability.

An organization's resources, processes, and priorities embedded in its business model show what it is capable of doing, but they equally show what it is *not* capable of doing. Thus, once a company—and indeed an industry—is developed, it is difficult to alter what the company will and will not produce by changing some regulations and thus incentives. Innovations that conform to the business model are readily funded. When an innovation emerges to address a new need in the market but does not fit the four elements of the business model, the organization sometimes rejects the innovation. More frequently, however, the organization co-opts such innovations by forcing them to conform to the business model to get funded.

One way to understand these forces is to visualize how the legislative process works. A congresswoman sees a pressing societal problem and envisions an innovative solution. She drafts the enabling legislation and introduces the bill. Within a few weeks, the labor unions inform her that unless she modifies the legislation to address their concerns, they will block it. She changes her bill to win their support. A short time later, the Chamber of Commerce announces its opposition to the bill unless it is modified in certain ways, so she again amends her proposal. Then she learns that a powerful senator will not support it unless she adds special considerations favorable to his state, and so on. To win the support needed for Congress to enact the proposed legislation into law, the congresswoman shapes the bill to fit the interests of those with powerful votes; as a result, what comes out at the end of the legislative process looks *very* different from what went into it.

The same forces are at work in every organization. Organizations shape every innovative idea to fit the interests of the groups that must support the proposal for it to receive funding. Innovative ideas never pop out of the innovators' heads as full-fledged plans. Rather, they are fragments of a plan. As the innovator tries to sell the idea to the powerful entities in the organization, he runs into hurdles that are frightfully comparable to those the congresswoman encountered. To win the support of those whose endorsement is critical to getting the innovation funded, the innovative idea morphs into a concept that fits the business model of the organization, rather than the market for which the innovator originally envisioned it. In other words, organizations cannot prioritize those things that do not naturally sustain and fit their processes, priorities, and economic models. This is a core reason why incumbent firms are at a disadvantage relative to entrant companies when disruptive innovations emerge.

As a result, when policymakers try to change existing regulations that alter the fundamental job the leading organizations have built a large, successful business model around, the members of the existing order will predictably fight it because meeting a new job is not something their core business can do naturally. In other words, the change in regulations will cause them to lose profitability. This is precisely what has happened with for-profit universities, as they have fought against any dramatic changes attempted in regulation and policy.[7]

It is not just companies in one part of the industry that will fight against change either. Companies are embedded in value networks, within which they establish their cost structures and operating processes and work with suppliers and channel partners to respond profitably to customers' common needs. Each of the players at different parts of the value network has its own business model, economic incentives, and rhythms of innovation and technological paradigms that are consistent and mutually reinforcing.[8] As a result, as companies grow and gather power, they build strong partnerships and constituencies embedded within the value network, all of which stand ready to support and defend the way they have always made money—which, in the case of education, is under a certain regulatory framework. Small changes or tweaks to that regulatory framework are not a problem, but ones that redefine the fundamental job or value proposition they are delivering are a real threat. This causes the coalition of groups to use its considerable resources to lobby against such changes. In the saga of for-profit universities, it has not just been the universities that have pushed back against a proposed overhaul in the regulations. Their partners, industry trade groups, and lobbyists, who have much to lose from fundamental changes, have also put up a formidable fight.

All this means that saying the customer always has the power is not quite accurate. In this case, the customer—the government—actually has far less power than it would like, as the causality of why products are made has to some extent been reversed. First, it is hard to fight against a group that has benefited mightily and built up substantial resources from the old regulatory order and has much to lose from a fundamental shift—and harder still if there is no strong constituency with plenty of resources that will benefit from and stand up for the new order. Second, even changing regulations to create different incentives will not create the new results politicians desire because the companies they want to change are, through no intentional malice on the part of their managers, nearly incapable of doing so.

In the case of for-profit universities, the Department of Education has been able to make some regulatory changes, but it has been a tough fight. The new regulations fall far short of the sweeping overhaul creating a new value proposition that some wanted to see. Instead for-profits have merely ratcheted back the sales culture, which is why some of the affected universities have responded by no longer offering incentives to recruiters for enrollment starts, for example. Nor has the final chapter in this story been written, as the new leadership in the House of Representatives has said it will push back on these regulations.

This analysis suggests that there is one dynamic that could change the equation. If an emerging group of disruptive companies began to amass resources and stood to benefit even more from a change in regulation that would reward the value proposition they delivered, this group could throw support behind the proposed changes *and* could deliver on the dramatic changes.[9] This would increase a politician's chances of success. Consider again the textbook companies and their business models that demand large volumes per title. As politicians in Florida and elsewhere have sought to use digital resources that begin to move the system toward a more modular, less expensive one—in the absence of disruptive companies and, perhaps even more importantly, a new channel of partners outside the standard textbook-adoption process ready to step up—these efforts have produced few real results and much frustration as new regulations have produced outcomes similar to those they sought to change.

Are Nonprofits That Different from For-Profits?

Does leaving for-profits out avoid the pitfall whereby the customer (the government) loses considerable power? Not really, because nonprofits and for-profits are far less different than many assume. Importantly, both for-profits and nonprofits have business models that define over time what they can and cannot do and prioritize.

Consider higher education. Some nonprofit career institutions in higher education as well as nonprofit industry groups, in addition to the for-profit universities garnering most of the attention, would be affected by changes to the gainful employment law currently being considered.[10] They are just as motivated as their for-profit counterparts to fight any fundamental changes. Even more visibly, in 2005 the Commission on the Future of Higher Education—also known as the Spellings Commission—announced its recommendations for reforming postsecondary education more broadly through tough accountability measures that would have dramatically changed the rules of the game for the majority of nonprofit and public universities. Just as for-profit universities have fought against changes to gainful employment, nonprofit and public universities were highly motivated to fight against these proposals and ultimately stymied any real changes. In other words, the incumbent universities had established business models that were not compatible with a new value proposition and were just as desperate to fight any changes that would undermine them.

Nonprofits, like their for-profit counterparts, have business models that allow them to deliver on their value proposition. Instead of a profit formula, they have what could be called a revenue formula, which serves a similar purpose. It dictates what funding nonprofits need to support their existing organizations in accomplishing their missions. Like for-profit companies in the disruptive diagrams, nonprofits and governmental organizations respond to similar incentives—only in their case, rather than pursuing profit, they pursue prestige. The ambition to do more and have a bigger footprint—an ambition driven both by administrators and alumni in higher education, for example—precipitates a behavior similar to profit maximization in the for-profit world. In addition, as processes and priorities coalesce in nonprofit organizations, just as in for-profit organizations, various groups often become entrenched in the organization's value network, and they naturally strive to expand, grow, and preserve themselves. Consider how difficult it is to introduce fundamental changes in the structure of a university. Faculty departments and members have a right to weigh in, and will do so, if they think the changes will affect their work in a negative way. As a result, fundamental changes to a university's business model are nearly impossible to make.

> Government policies have not focused on lowering higher-education costs or on graduating more people. Instead, the government pays money for enrolling students.

In higher education, this has led nonprofits to respond to incentives just as for-profits have. The so-called California master plan adopted in 1960—which established by law whom the University of California, California State University, and community college systems could serve—cemented the definition of quality and thus what their upward trajectory would look like. It established that the colleges allowed first crack at the brightest students, as measured by standardized tests, would "also get the most money, enroll the most graduate students, run the biggest research projects, and have the most prestige."[11] Other states adopted similar plans over the next decade, which triggered a race to move up the ranks to "be eligible for more cash from federal and state governments, not to mention alumni. . . . Whenever and wherever they could, normal colleges became state teachers' colleges, became state colleges, became state universities. The best proxies for prestige are spending per student and selectivity, both of which drive up costs. The perception, and sometimes the reality, has been that colleges for the poor must be poor colleges."[12]

The popular perception that for-profit universities have lower graduation rates than nonprofits—although true in the aggregate—is not in fact true when controlling for serving a higher percentage of high-risk students.[13] For-profit universities not only serve more high-risk students on average—by roughly 20 percentage points—but some research suggests that they also deliver graduation rates that are significantly higher than their nonprofit

and public counterparts for this population.[14] A key reason for this may be that the majority of nonprofit and public universities have strong incentives to serve the brightest students with the most potential and strong disincentives to serve high-risk students because the government does not tie more money and incentives to graduating them. In other words, the nonprofit and public universities, like their for-profit counterparts, follow their incentives and do the job the customer has historically asked them to do. Again, if there are "smart" regulations and policies in place that cause the government customer to make "smart" purchasing decisions, universities will do "good" things. If there are "stupid" ones in place, they will do "bad" things.

Another perceived difference between for-profits and nonprofits manifests itself in two ways—either that for-profits are inherently motivated to cut costs at the expense of serving the customer or the reverse, that nonprofits inherently have less discipline in controlling costs and therefore for-profits can be far more streamlined and efficient to the benefit of the taxpayer and end user. It is certainly true that there are strong incentives in place for for-profit companies to cut costs to increase profitability. But they are not motivated to do this at the expense of customer satisfaction. Recall the earlier analysis. For-profits are highly motivated to make better products that they can sell for better profits to their best customers, but they are not motivated to do things that will not allow them to make better products for their best customers for better profits. If something in a product or service is critical to a customer, for-profits are not motivated to shortchange it because their customers will punish them—by choosing another vendor—for doing so. But if customers do not signal that something is important—by showing no change in their willingness to pay—for-profit companies are willing, and sometimes quick, to cut the offering if it is not valued. As a result, if successful for-profit companies are shortchanging the government, it is generally because the government has not put in place the correct incentives and regulations that pay for the value proposition it wants.

The emerging segment of K–12 online learning companies provides further evidence that for-profit companies have a strong disincentive to cut corners if it would compromise the quality their customers demand. As the leading for-profit providers who make the bulk of their money in K–12 schooling, K[12] Inc. and Connections Academy have clear incentives both to comply with No Child Left Behind and other accountability measures and to avoid doing anything that would provoke news stories that question their ability to run and manage schools. Such behavior—even in an isolated case—would quickly unravel much of what they have built and potentially destroy their businesses. They therefore have strong incentives to offer an efficacious product that does no harm—and to avoid cutting corners that their customers value—even as they also have an incentive to streamline operations where possible to give their shareholders better returns.

If an emerging group of disruptive companies stood to benefit from a change in regulation, this group could throw support behind the proposed changes *and* could deliver on the dramatic changes.

A key question arises from this: when for-profits improve profitability and streamline operations, does the government spend less and get similar outcomes—thereby allowing taxpayers to keep more of their dollars—when contracting with for-profit providers? In education, the answer historically has been no. This is not to say that there are not mechanisms that could make this happen, but to this point, because funding tends to be determined through formulae based on inputs, the cost of services in previous years, and other such factors, the true cost has been tough to identify. Although for-profit universities operate at lower costs than their nonprofit and public counterparts on average, their tuition prices are often the same or higher, which means that the public often has to pay more money through Title IV financing. The same has largely been true in K–12 education. Although a district may find a vendor that offers services for less, this frees up resources to be spent elsewhere, not to return funds to the government or taxpayers.

As a result, to this point, though there are those who claim that the for-profit sector would save taxpayers more money than nonprofits or public universities, the evidence for this is not clear. Ultimately, all entities that serve the public—whether for-profit, nonprofit, or governmental—are public entities in some sense because they are publicly funded. Advances in education policy may change this,

but for now, the refrain that the for-profit sector saves the public money has not proved true.[15]

In sum, those who want to castigate for-profits or nonprofits as inherently good or bad often are categorizing the world in the wrong way. Government should not discriminate between for-profits and nonprofits as a matter of blanket policy. Instead, it should ask if the company with which it is contracting, for-profit or nonprofit, is delivering on what society is paying it to do, as determined by both the spirit and letter of the law. And policymakers more broadly should be asking if the law is asking these organizations to do the right thing.

Scale, Focus, and Attractiveness: The Differences between For-Profits and Nonprofits

Although there are many similarities between for-profits and nonprofits that run counter to conventional wisdom, they do have some inherent and important distinctions that stem from their fundamentally different corporate structures.

Scale. For-profit corporations have owners or shareholders; nonprofit corporations do not. This means that for-profits do not reinvest all their profit into their core business, as successful nonprofits do, but instead return some of that profit to the owners. Although many in education believe this is a bad thing, it actually has huge benefits for a sector trying to attract more, not less, capital and create sustainable success (and given that for-profits will not take shortcuts if their customers will punish them for doing so, it has fewer risks than many believe). Because for-profits return money to their owners, they can naturally attract even more capital to grow and scale operations and attract more top talent when there is a viable market. The reason is that shareholders invest to make returns, so capital flows naturally to places where those returns will be most attractive. To maintain attractive returns, for-profit companies have to deliver results that offer an upside surprise to their investors because investors discount a company's stock price by whatever rate of growth they foresee a company achieving. In other words, expected growth—no matter how fast—is already factored into the share price. To satiate investors' needs, companies have to grow faster than shareholders expect. This drives them to find ways to scale an effective business model as quickly as possible. Capital, in turn, is always searching for companies that can offer that surprise—and pushes for-profit enterprises to scale faster.[16]

By not having shareholders, nonprofits lack this natural pathway. Although many have tried to bring investment principles to the nonprofit sector in choosing which organizations they support and how they fund them, in many cases, these actors (often foundations and philanthropists) in fact operate like customers—as they provide the revenue that sustains the business, not growth capital in addition to revenue. As a result of these dynamics, for-profit companies spend between $2 and $4 raising capital for every $100 they bring in, whereas nonprofits spend $10 to $24 for every $100 they raise.[17]

In education, this is a principal reason why for-profit universities have been able to seize the advent of online learning, a technology that enables disruption, and scale much faster than their nonprofit and public counterparts. Seeing the market opportunity to create new models that serve adults learners and others—particularly minorities and low-income students—who have historically been overlooked by traditional universities, for-profit universities have tapped vast sums from private capital markets to create offers that do the job the government has paid them to do: expand access to postsecondary education.

Focus. Because of this clear pressure and drive to deliver for their shareholders, successful for-profits tend to have a crystal-clear idea of what their metrics and "bottom line" are. If they do their job well, they make more money, which equates to success (even if it ultimately leads them into the innovator's dilemma, in which by consistently choosing to make products with higher margins over those with lower margins, companies ultimately open the door to their disruption).

Nonprofits lack an easy metric, such as shareholders demanding monetary returns, which makes it relatively harder for them to focus and judge if they are successfully delivering on their mission. There have been suggestions of how to overcome this—such as measuring success by whether the cost of customer acquisition falls over time[18]—but to date, none of these suggestions has become commonly accepted wisdom and practice across the whole sector.

This focus problem is one of the reasons why nonprofits, on average, are slower to streamline operations and redirect dollars to more useful pursuits. Such shifts are often slowed at for-profits and nonprofits because of personalities or attachments—managers may have personal relationships with people they need to let go, veteran employees may like certain perks, and groups will

fight to preserve themselves. But without investors to reap the benefits of new efficiencies and push aggressively for cost savings, nonprofits tend to make the switch much more slowly in the absence of a certain kind of leadership or clear metrics. Self-interest tends to encourage a more aggressive pace at for-profits.

Creating policies that first and foremost reward and pay for outcomes is vital, as it will align the interests of for-profit companies around the correct end goals.

What Opportunities Appear Attractive. Nonprofits play an important role because not having shareholders allows them to remain invested in a sector even in the absence of a viable market. The K–12 online learning world presents a classic case. Two of the more successful companies, K[12] Inc. and Connections Academy, are, as discussed earlier, highly motivated to do the jobs that their customers pay them to do and deliver a quality education. What is also intriguing, however, is what these companies are not motivated to do. Although both offer a high-quality curriculum, it is in essence a fixed and linear one. Their learning software is *not* built on an adaptive-learning platform, one that is automated to offer curriculum in a nonlinear fashion by improving the quality of what it offers each individual student in real time—much as Netflix, Pandora, and Amazon do for movies, music, and books. Neither one has made the sizable investment in a next-generation curriculum—which would likely be, for them, a sustaining innovation. The reason is that their best customers will not reward them for doing so. There is no viable market with the needed critical mass among states and districts. Indeed, current policies encourage school districts to make their purchase decisions based on price, not efficacy. Districts are motivated to increase offerings, save money, and offer something that aligns to standards—but there are not many incentives to do more than that.

A case study of an educational startup company called Time to Know presents more evidence for this. The company spent at least $60 million on developing a beautifully engineered and polished curriculum that pushes the envelope, yet it has struggled to gain rapid adoption by school districts. The company is naturally mystified because, from their perspective, they are offering a "great" product. Why aren't more districts realizing this and buying it? One reason is that many districts do not define quality in the same way—and quality can only be defined in relation to the job customers will pay for. To make a reasonable return on the big up-front investment, Time to Know must either enroll lots of customers quickly or charge high amounts. But by targeting price-sensitive districts with long buying cycles, the company risks running into a significant headwind.

In contrast, the Florida Virtual School (FLVS), a public online school, has already experienced success as an early leader in the K–12 online learning movement; FLVS is now pioneering new approaches to learning such as video game–based courses and constructive curricula. At this point, there is less concrete evidence about the efficacy of these approaches and, more significantly, unclear willingness on the part of customers to pay. One of the reasons FLVS might be able to pursue approaches that are not yet highly valued in the marketplace is because it is not a for-profit. It therefore does not have shareholders who would discourage it from going in this risky direction. Hence, nonprofits (and, in this case, governmental organizations) can still operate in an arena where there may be a pressing public need but few customers with the willingness or ability to pay for a product or service—in which case it is nearly impossible to make attractive profits or returns for investors. Unlike their for-profit counterparts, with the generous gift of just one individual (or foundation)—who is not expecting returns and therefore is not a shareholder, but instead is essentially the paying customer—nonprofits can support an operation to serve these types of missions. This circumstance will most often occur in niche areas with little demand (where it is hard to galvanize a market). In this way, nonprofits can inspire action even in the absence of a traditional, well-functioning market.

Conclusion

As AEI's Frederick M. Hess wrote, "So long as we recognize that it is no wiser to romanticize them than to demonize them, we absolutely ought to welcome for-profits into the education sector."[19] For-profits are not inherently good or evil, and they have far fewer differences from nonprofits than most assume. Indeed,

successful for-profits and successful nonprofits share many characteristics.

But there are some important differences between for-profits and nonprofits in their fundamental corporate structure that allow for-profits to more readily address the struggles faced in education—from finding sources of capital to sustainability and scale. If people want investment and capital to flow into and support the education sector, the most natural way is to enable self-interest to take hold by allowing for-profits to operate in a functioning marketplace. For that reason, the US government's decision to favor nonprofits and public operators and to marginalize for-profits in areas such as I3 and higher education appears shortsighted. Whenever the government creates a market as the customer for services, by allowing for-profits to compete it creates a multiplier effect, whereby private capital comes in on top of the government's funds to create scale. As a result, if they are performing a valuable service that society considers "good" and there is a robust market opportunity, then for-profits have a more natural ability to scale a solution. This, along with their laser focus, can therefore be a critical tool in a policymaker's arsenal—one reason why Secretary of Education Arne Duncan has said that for-profit universities are vital for realizing President Barack Obama's goal of dramatically expanding the percentage of Americans with postsecondary credentials.

Of course, for-profits do present some risks. With bad policies in place that reward the wrong things, scaling up a solution rapidly can create a significant problem, as it will create an industry intent on maintaining the status quo before the government has time to alter its policies appropriately. This is not unique to education. The government faces this problem in all sectors when it acts as the customer. In the absence of perfect foresight, the best the government can do in creating a market to solve a problem is to be clear about the goals and spirit of its policy and proceed with a measured approach to creating new programs by recognizing that they may not be successful.[20] In addition, creating policies that first and foremost reward and pay for outcomes, as well as efficiency or productivity—and do not regulate the inputs or processes to achieve those outcomes—is vital, as it will align the interests of for-profit companies around the correct end goals. To date, federal, state, and local governments in the United States have done little work in creating policy in this vein.

Crafting smart policy is a vital job of elected officials. Ceasing to use the benefits that for-profits bring is not smart policy. It does not address the root causes of misaligned incentives, and it potentially shortchanges the public good by making it harder to scale solutions. It also perpetuates many of the stereotypes in education that have held back these potential forces for far too long. Although for-profits are not a panacea for what ails society, using what they do well in conjunction with policy that rewards the right outcomes—and is open to an honest debate about what those should be—can start to move us closer to solutions that have a far better chance of working at scale.

Notes

1. For the full explanation of this phenomenon, see Clayton M. Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Boston: Harvard Business Press, 1997); and Clayton M. Christensen and Michael E. Raynor, *The Innovator's Solution: Creating and Sustaining Successful Growth* (Boston: Harvard Business Press, 2003), chapter 2.

2. For a full discussion, see Clayton M. Christensen, Michael B. Horn, Louis Caldera, and Louis Soares, *Disrupting College: How Disruptive Innovation Can Deliver Quality and Affordability to Postsecondary Education* (Washington, DC: Center for American Progress, February 2011).

3. Clayton M. Christensen and Kirsten Shu, "What Is an Organization's Culture?" (Harvard Business Press, August 2, 2006), 2.

4. Clayton M. Christensen and Stephen P. Kaufman, "Assessing Your Organization's Capabilities: Resources, Processes, and Priorities" (Harvard Business Press, September 13, 2006), 2.

5. Even not-for-profits and government units have business models. In their case, the last box may be more aptly titled "Revenue Formula" rather than "Profit Formula"—as it is the funding they need to support their organization in accomplishing its mission.

6. Clayton M. Christensen, Jerome H. Grossman, and Jason Hwang, *The Innovator's Prescription: A Disruptive Solution for Health Care* (New York: McGraw-Hill, 2008), 8–10.

7. There is actually a reliable pattern to how this operates in regulated industries. In the early years, when technology is not good enough to deliver the public good in a reliable way, government regulation can play a critical role to promote stability and assurance. The problem comes when these rules survive long after the public need for stability and assurance has been satisfied by technological progress. Although the original intent of permits and certification is a genuine concern for the end user, the rules almost always come to be used to protect the economic interests of the existing providers—still invoked, of course, in the name of the end user (or the "public good"). The implication is that regulators must continue to change the focus of their rules as science and technology progress, but the reality is they rarely do. Over time this creates large and powerful companies who have a vested interest in preserving the status quo. When policymakers try to change the rules, these incumbents fall back on their arguments of stability and assurance to block the changes. See Clayton M. Christensen, Jerome H. Grossman, and Jason Hwang, *The Innovator's Prescription*, 382–83.

8. Clayton M. Christensen, *The Innovator's Dilemma*, 29–59.

9. When stuck in this situation, the need for disruptive innovation becomes acute. This is in part why the US government has historically been so concerned with breaking up monopolies. It is interesting to see what ultimately breaks up the monopolistic practices. It is rarely the

actions of the Department of Justice. Instead, it is disruptive innovation. It was not the Department of Justice that ended IBM's, Microsoft's, or Xerox's monopoly through its extensive litigation. Instead, it was the disruption pioneered by the personal-computer industry, led first by Apple and later by Dell, Microsoft, and Intel, all of which made the computer much more affordable, simple, and convenient for many more people; Linux, which did the same for server operating systems; and Canon, which led a stream of new photocopying innovations that made the photocopier dramatically more accessible to many more people—all three by avoiding head-on attacks at the outset.

10. The proposed set of gainful employment regulations has its roots in the Higher Education Act, which requires that career colleges and occupational training programs prepare students for "gainful employment" to remain eligible to receive federal financial aid. In July 2010, the Department of Education proposed a set of regulations to define gainful employment as a measurable outcome based on student debt-to-income levels and loan-repayment rates. These regulations would apply to all programs at for-profit colleges and to occupational training programs at public and nonprofit colleges. Programs that fail to meet gainful employment benchmarks would have their access to federal student aid restricted or completely denied. Because these regulations specifically target for-profit colleges, opponents of the gainful employment rules say these institutions are being unfairly singled out and have lobbied fiercely to put a halt to the rules' implementation.

11. Anya Kamenetz, *DIY U: Edupunks, Edupreneurs, and the Coming Transformation of Higher Education* (White River Junction, Vermont: Chelsea Green Publishing, 2010), chapter 1.

12. Ibid.

13. The Department of Education defines high-risk students as having three of the following characteristics: delayed enrollment, no high school diploma, part-time enrollment, financially independent, have dependents, single-parent status, and working full time while enrolled. Students with these traits map strongly to inner-city residents, low-income households, minority status, and first-generation postsecondary students.

14. Robert Lytle, Roger Brinner, and Chris Ross, *Private Sector Post-Secondary Schools: Do They Deliver Value to Students and Society?* (Boston: Parthenon Group, February 24, 2010).

15. Some recent proposals are trying to attack this problem. In K–12, two articles give some preliminary ideas for how this could work. See Dakarai Aarons, "San Francisco Creates College Accounts for Kindergartners," *Education Week*'s District Dossier blog, October 5, 2010, http://blogs.edweek.org/edweek/District_Dossier/2010/10/san_francisco_creates_college.html (accessed April 12, 2011); and Frederick M. Hess, "Proposals for a Cost-Conscious Era: K–12 Spending Accounts," *Education Week*'s Rick Hess Straight Up blog, October 15, 2010, http://blogs.edweek.org/edweek/rick_hess_straight_up/2010/10/proposals_for_a_cost-conscious_era_k-12_spending_accounts.html (accessed April 12, 2011). In higher education, see the discussion of the QV Index in Clayton M. Christensen, Michael B. Horn, Louis Caldera, and Louis Soares, *Disrupting College: How Disruptive Innovation Can Deliver Quality and Affordability to Postsecondary Education*.

16. See Clayton M. Christensen and Michael E. Raynor, *The Innovator's Solution*, introduction.

17. William F. Meehan, Derek Kilmer, and Maisie O'Flanagan, "Investing in Society: Why We Need a More Efficient Social Capital Market—and How We Can Get There," *Stanford Social Innovation Review* 1, no. 4 (2004). Given this fundamental difference in corporate structure, a more apples-to-apples comparison might treat the money that nonprofits raise as one source of their overall revenue and think about their expenses against that as their costs of goods sold. In this case, the funders (or customers) are in fact hiring the nonprofits to do what they deem to be an important job, and nonprofits tend to align around what their funders want, just as all successful enterprises align around their customers' jobs to be done, not necessarily the end user's. Because nonprofits do not have equity, they do not, to date, identify fundraising dollars as growth capital.

18. One problem with this is that although the cost of customer acquisition may fall because the true customers are often those giving money to the nonprofit, not the clients being served by the mission, the success of the nonprofit is in fact dependent on having customers—foundations, individuals, and so on—who are completely aligned with the nonprofits' clients' true job. That alignment is likely rarer than we might hope. Indeed, when CEOs of nonprofits complain that they are spending 65–70 percent of their time fundraising, which leaves little time for actually running their nonprofit, what they often do not realize is that this is where they are leading their nonprofit. In an odd way, the original mission for the clients becomes secondary in some cases.

19. Frederick M. Hess, "The For-Profit Question," *Education Week*'s Rick Hess Straight Up blog, May 24, 2010, http://blogs.edweek.org/edweek/rick_hess_straight_up/2010/05/the_for-profit_question.html (accessed April 12, 2011).

20. For example, one policy option would be to have measures in policy that sunset a program if its outcomes do not justify the costs compared to other programs designed to achieve similar outcomes. Policies of this nature might then treat new programs not as victories in and of themselves, but instead as experiments whose perpetuation would be determined based on how they are executed.