Lessons of Market Creation from Around the World

By Michael Q. McShane
American Enterprise Institute
Michael.McShane@aei.org

Papers for this conference are available online at:
http://www.aei.org/papers/school-choice-encouraging-new-and-better-schools/
Introduction

After the decline and collapse of the Soviet Union, numerous countries around the world decided to move sectors of their economy from public monopoly control to private ownership and operation. From mail delivery in Japan to copper mines in Zambia to oil and natural gas production in Russia, a wide and varied set of activities was subjected to the increasing presence of market forces.

In many areas, transition has been a clear net positive. In the Baltics and in Central Europe many countries made successful transitions to market economies and burgeoning democracies. According to a November 2013 analysis by the Economist, Latvia and Lithuania were the two fastest growing nations in Europe in terms of GDP from 2012 to 2013, with Latvia growing at over 4 percent and Lithuania growing at over 3 percent. This happened while Europe writ large saw a decline of 0.5 percent over that same time period. After Vietnam liberalized its economy following a series of reforms in 1986 it has experienced one of the highest rates of growth in the entire world. Vietnam still has serious human rights, press freedom, and governance issues to work though, to be sure, but these first economic steps have proved promising.

Unfortunately, in many other countries, the transition to market economy has been a bumpy ride. When Russia privatized its state-owned enterprises, it traded government monopoly for a corrupt cronyist oligarchy. Gazprom is a perfect example. Gazprom was the publicly traded natural gas company born in the Boris Yelstin years out of the state monopoly. Russia broke up its state monopolies by giving citizens vouchers to purchase shares in newly privatized businesses. Initially, Gazprom was owned 15 percent by its employees, 40 percent by the state, and 55 percent by private citizens. When Yeltsin appointed the former chairman of the board
Viktor Chernomydrin Prime Minster, he was able to ensure that Gazprom was loosely regulated. As a result, company executives participated in a process economists call “asset stripping,” selling off key elements of the business to their cronies and leaving the government and shareholders holding all of the debt. This process, repeated in industries across the Russian economy, created a class of super-rich oligarchs at the expense of the Russian people.³

In this set of papers, we are talking transitioning a part of one sector of the economy, the $700 billion per year K-12 education industry, from public monopoly to private management. There are several key lessons that we can learn from previous attempts to manage this transition from around the world.⁴ Fundamentally, the lesson from Europe, Asia, Africa, and Latin America is that liberalization—that is, simply transitioning the industry from public to private control—is not enough. At the same time markets are liberalized, concomitant reforms to stabilize pricing must occur and complementary institutions must be created to regulate markets, provide access to capital, and groom the human capital pipeline for these new industries.

**Liberalization, Stabilization, and Institution Building**

In a 1993 book for the Council on Foreign Relations aptly titled *Making Markets*, economists Shafiqul Islam and Michael Mandelbaum edited a series of papers examining the transition to market economies around the world.⁵ At the time, the fate of such markets was unclear. As London Business School economist Richard Portes points out in that volume, Central Europe fell into a deep depression in the immediate period following transition to a market economy (the early 1990s). From 1990–91 Poland’s gross national product fell 21 percent. Hungary and
Czechoslovakia were in rough shape as well, with economic contractions of 12 percent and 16 percent of GNP respectively in 1991 alone.\(^6\)

But leaders held firm in their decision. A market-based economy walks hand in hand with democratic government, or as Mandelbaum puts it:

Central planning goes hand in hand with authoritarian rule. The market system, by contrast, is compatible with democratic politics. At the heart of both the market and democracy is individual freedom-to engage in economic and political activities, respectively. Both embody the principle of popular sovereignty: just as democratic governments are chosen by popular vote, so market economies are partly driven by the decisions of individual consumers.\(^7\)

It is clear they were not going back. But that is not to say the transition to a market-based economy was going to be easy. Over the course of the next two decades, states rose and fell, bubbles inflated and burst, employment spiked and cratered, and the political control of politicians remained tenuous. Looking back on this difficult time, economists and political scientists have gleaned several lessons from what made some countries more successful than others.

In the introduction to *Making Markets*, Mandelbaum highlights three actions that must take place in order to facilitate a successful transition from centrally-planned to market industries: *liberalization*, *stabilization*, and *institution building*.

*Liberalization* is the most straightforward of these processes: it involves injecting market forces where previously there was government control. Primarily, this involves breaking up government monopolies and turning them over to private control. In most states, this meant
dismantling large industries, like automotive production, banking, or natural resource
development, into several private companies that would then give or sell stock to citizens. For
example, in 2015, the Japanese Government plans to sell off two-thirds of its former mail,
insurance, and bank conglomerate Japan Post. This liberalization will move management of the
various branches from government control to the control of private shareholders.  

Liberalization also involves creating a “hard” currency that could convert to foreign
 currencies to allow normalized foreign trade. For example, for decades the value of the Russian
ruble was controlled by the government and used in combination with vouchers and trading
stamps for the purchase of services. As a result, there was no clear way to convert the value of
that currency to US dollars, to Swiss Francs, or to whatever currency cross-state commerce
required. As Russia has developed its market economy, the value, stability, and frequency of the
ruble has grown. 

Stabilization attempts to deal with the massive price distortions that central planning
produces. Because markets are not allowed to set prices for goods and services in a government
monopoly, they can become disconnected from the costs of production. If, for example, the
government wanted everyone to be able to buy coal in the wintertime, it might ratchet down the
retail price of coal to below what it costs to mine it out of the ground. To pay for this, it would
ratchet up the cost of some other good or service to offset the distortion. In Poland, government
officials artificially kept farm product prices low to keep food costs for urban industrial workers
low. This resulted in massive deficit spending and the depression of agricultural production, as
farmers did not think they were being adequately compensated. Distort prices for political
reasons enough times and no one knows the true cost of any good or service. When transitioning
to a market-based system, there can be huge shocks when prices get more in line with costs. But,
that must take place in order to accurately compensate individuals for their labor and the cost of their goods. Stabilization also attempts to deal with the aftermath of transition, including inflation, unemployment, and the political instability that inflation and unemployment cause.

Finally, institution building works to create all of the organizations and structures that allow markets to work. The first of these is regulation. Massive, byzantine regulatory structures develop in centrally-planned economies. Because there are no market forces to keep prices accurate and costs down, central bodies have to decide how to allocate capital to enterprises. To do this, they write regulations governing the distribution of funds and work rules for employees of firms in order to allocate their human capital. Markets do not work like that. Competition for goods and services generally keeps prices under control, but regulators need to ensure that these forces do not lead to dangerous or mislabeled products. Competition for workers ensures that industrialists cannot set too low of wages or have too poor of working conditions or their workers would go elsewhere. Regulation here steps in when workers lack other options and are thus at the risk of mistreatment.

A second facet of institution building is in the organizations and institutions that drive the human capital pipeline. Thriving as a worker in a government-run monopoly requires a different set of skills than thriving in a market-based industry. Entirely new laws are written that managers need to comply with and lawyers need to interpret. New financial instruments are introduced to finance businesses and accountants need to learn to accurately report the debits and credits of production. Business owners need a new skill set; rather than simply keeping the political boss above them happy, they now must identify their place in the market and learn how to keep their costs low and their quality high.
Individually, these represent necessary, but not sufficient, conditions for successful transitions to a market-based system. If care is not taken in all three areas, there are problems. An example of this arose during the privatization of copper mines in Zambia. Even though management of the mines was moved from public monopoly to private control in the 1990s (liberalization) because of inadequate institution building, mine operators did not have a clear legal framework within which to operate. This scared off necessary foreign investment, meaning the Zambian miners did not have financial instruments to purchase new equipment to better mine copper. They also lacked the human capital in locally-educated engineers and managers to plan and operate the mines. Even though global prices for copper shot through the roof post-privatization, the industry, and the country as result, continued to struggle.

Liberalization, Stabilization, and Institution Building in Education

So what do these processes look like in education? Liberalization is probably the most straightforward—it means injecting market forces into the education system by empowering families to choose the schools their children attend at the public’s expense. This could take the form of vouchers or tuition tax credit scholarships as currently understood, it could be education savings accounts or course choice programs, it could be charter schools, or it could be financing mechanisms that have not emerged yet. As long as the funding mechanism “follows the child,” that is, it allows parents to choose freely between multiple competing schools, it can be said that the process has been liberalized.

Education thinkers for decades have written about liberalizing education. Nobel Laureate Milton Friedman’s 1955 essay “The Role of Government in Education” makes the case about as
well as anyone has. In that essay, he argues that society has an obligation to provide for the education of children both to empower individuals to participate in economy as well as know their rights and participate in government. In his vision:

Governments could require a minimum level of education which they could finance by giving parents vouchers redeemable for a specified maximum sum per child per year if spent on "approved" educational services. Parents would then be free to spend this sum and any additional sum on purchasing educational services from an "approved" institution of their own choice. The educational services could be rendered by private enterprises operated for profit, or by nonprofit institutions of various kinds. The role of the government would be limited to assuring that the schools met certain minimum standards such as the inclusion of a minimum common content in their programs, much as it now inspects restaurants to assure that they maintain minimum sanitary standards.

But even Dr. Friedman knew that liberalization in and of itself was insufficient. He begins a paragraph near the end of his description of this system by stating, “Many detailed administrative problems would arise in changing over from the present to the proposed system and in administering the proposed system.” While he argues that they are “neither insolvable nor unique,” they are there, and are dealt with by the other two legs of the market-creation stool.

The second leg, stabilization, is a bit more complicated. Like in many government-monopoly controlled businesses the cost of education has become distorted. Put plainly, we have no idea what the true “price” of a K-12 education is. Generally, the amount of funding for a particular child is determined through a political process and is often driven as much by
competing claims on tax dollars for roads, healthcare, or prisons as it is on determining how much money is actually needed to educate a child. To stabilize costs in education, the funding mechanism needs to float—it needs to allow money to be fungible enough to encourage competition from providers. Currently school vouchers, tax credit scholarships, charter school allocations, and even course-choice dollars are funded “all or nothing.” If a student chooses to go to a private school or take a class from a private provider a lump sum is given to the school to pay for it. Like with traditional public schools, that sum is almost always determined politically as some percentage of the money distributed to traditional public schools. It is not determined on what an education actually costs.

As Matthew Ladner demonstrates, an educational savings account-like model is one promising tool available today to try and set accurate prices. Education savings accounts, like the Arizona Empowerment Scholarship Account program designed for students with special needs, are created by governments for the specific use of financing children’s education. Every year, the government places a particular amount of money in the account that can only be used for education expenses. Any money not used that year can roll over and eventually be put towards college education or cashed out. Because owners of education savings accounts are not required to spend all of their dollars in one lump sum, they are incentivized to find lower cost providers. The money simply becomes theirs to use with the slight condition that its use is restricted to certain approved education purchases. This allows for competition on price. If providers ask for too much, parents can find another option. If they ask too little, they cannot make payroll. As a result and over time, prices should stabilize.

Institution building is another complicated factor. First, new regulations will need to be developed. The state-led school and teacher accountability systems of today are designed to
regulate a monopoly. Because a large number of parents cannot choose where their children attend school, the state plays an active role in ensuring as best as possible that those schools are high quality. States require testing, they use those tests to grade the school and the teachers within it, and they reward and sanction accordingly. These heavy handed approaches are inappropriate for governing a marketplace. Regulation of a marketplace is much more about creating floors and ensuring accurate labeling, thereby protecting consumers from harm, than it is about trying to measure and react to gradations in quality. In order to move to a market regulatory system, the types of behaviors and indicators that regulators track will need to change, as will the carrots and sticks used to alter performance.

When it comes to human capital, new institutions and organizations will need to emerge to train teachers and leaders in market-responsive schools. The skill set of a traditional public school leader is different than that of a leader of a school trying to compete in a marketplace. It is a well-documented phenomenon that traditional schools are stymied by a culture of compliance, in large part driven by the paperwork and often incongruous requirements pushed down to school by the federal, state, and local government. Many principals are forced to spend large amounts of their time as bureaucrats, preparing reports for the local district, the state, and the federal government, and have to be responsive to the whims of their superintendent or local school board. A leader of a school in a marketplace has a completely different set of tasks. He or she must operate much more like the CEO of a small company than a government functionary. He or she has to identify a target audience, market to them, adapt to changing market conditions, manage payroll, maintain compliance with the mandate of public dollars coming into the school from various programs, and be an instructional leader. This will require new and different training.
Type I and Type II Reforms

Another hard-won lesson of transitions from monopolies to markets is that some of these reforms are more difficult in practice than others. In an analysis of the transition to market economies of central and eastern Europe as well as the former Soviet Bloc nations, economists Jan Hanouskek, Evzen Kocenda, and Jan Svejnar share the same concerns as most observers of the shift from monopoly to markets: “From the start it was clear, however, that privatization in and of itself would not be sufficient to ensure an effective functioning of the newly created market economies.”

Hanouskek, Kocenda, and Svejanar break down necessary reforms into two baskets: Type I reforms and Type II reforms. Type I reforms included “macro stabilization, price liberalization, and the dismantling of the institutions of communist system.” Type II reforms included “development and enforcement of laws, regulations, and institutions that would ensure a successful function of a market-oriented economy.” As one might imagine, Type II reforms proved much more difficult to implement than Type I. In fact, according to the authors, “the lack of a market-oriented legal structure appears to have been the Achilles heel of the first dozen years of the transition.”

So what made the difference between states that successfully made the transition, like the countries of central Europe and the Baltics, and those that did not, like the Balkans and former members of the Commonwealth of Independent States? The authors argue that success depended on two factors: “their ability to collect taxes and finance public programs, and their ability to minimize corruption and rent-seeking behavior.”
It is worthwhile to unpack both of those necessary conditions with respect to education. When it comes to financing, it is not simply enough for policymakers to create a meagerly funded program, brush the dust from their hands, and walk away. For new schools to emerge, or for serious scaling to happen in existing schools, there will be upfront costs that schools need to bear. If there is not a mechanism to provide this capital, there will not be growth. Programs that are simply funded for the marginal cost of adding a student will not build new schools.

Take for example the Cleveland Scholarship and Tutoring Program. First launched in 1996, this program was the impetus for the landmark Supreme Court ruling on school vouchers, Zelman v. Simmons-Harris, which ultimately found school vouchers to be constitutional. The program allows parents in the attendance zone of the Cleveland Metropolitan School District to apply for a voucher of up to $4,250 for grades K-8 and $5,700 for grades 9–12. On average, the voucher amount for a participating student is just under $3,330, only 29 percent of the average per-pupil spending for the state of Ohio. This is simply too little money to start a new school: Almost 20 years in, only 35 schools have chosen to participate in the program, offering seats to 6,000 students, less than 12 percent of the total student population in the city. If the goal of such a program is to open up a marketplace, such restrictions have prevented it from doing so.

Reducing corruption and rent seeking may be the most important feature of transitioning from a public monopoly education system to one that leverages markets. One must only look at Russian oligarchs today to pause when thinking about moving from government control to private management. There are also numerous horror stories from the private and charter sector of unscrupulous school operators lining their pockets by bilking programs for hundreds of thousands of dollars.
Combating corruption, like central and eastern Europe learned, requires both laws and enforcement. In education, the laws include clear definitions and expectations for financial and performance transparency, and triggers for deeper state scrutiny should red flags be raised. Enforcement requires the creation of new bodies, perhaps accreditors or even regulators within a state or district education agency, that are tasked with overseeing these new schools. It is essential that they understand how private schools work.

Harvard Graduate School of Education professor Jal Mehta and Johns Hopkins Political Scientist Steven Teles offer an idea of how to create such bodies in education. In a model they call “plural professionalism,” rather than having one body oversee all schools, individual schools or school networks would establish relationships with accrediting bodies specific to their particular models. These accreditors would oversee teacher preparation programs as well as individual networks of schools, and schools would work with accreditors to develop the set of metrics that they would be judged against. If, for example, a school eschewed standardized testing, the school could work with the accreditor to develop metrics of college-going rates, portfolios of student work that are representative of the rigor of the school’s expectations, or any number of other metrics that the school and accreditors would agree on. The state would approve the agreement and monitor the accreditors, and would use the accreditors as the accountability tool.

Rent seeking, and its most pernicious incarnation regulatory capture, is another troubling issue. Rent seeking involves individuals using political influence to give themselves an unfair position in the marketplace. Regulatory capture occurs when the proverbial fox guards the chicken coop and regulators are either unfairly harsh or unfairly lax on particular groups to help them or harm them in the marketplace. Given the fact that educational enterprises employ at
times hundreds of workers and operate with multimillion dollar budgets, the fear that dirty politics will drive investment and regulation is perfectly reasonable. In the “plural professional” system, the idea is to prevent people who have inherent biases against particular types of schools from being the ones that regulate them, and to ensure that those who do the regulating know what they are looking for. This leads, quite reasonably, to fears of collusion between private schools and those who are supposed to hold their feet to the fire.

Russia again offers a cautionary tale regarding regulatory capture. When a small number of connected individuals were able to tilt the legal system to their advantage, they reaped great profits. In fact, 35 percent of the total wealth of that nation, the 9th largest in the world by population, is held by only 110 individuals. This rent-seeking behavior had a negative effect on both the politics and economics of Russia as a whole. However, several countries were able to dissolve state owned assets without creating a class of corrupt oligarchs, and we can learn from them.

Vigilance appears to be the key in guarding against the negative effects of rent seeking and regulatory capture. In states like the Baltics and central Europe, state-owned enterprises were broken up in a more transparent and equitable way, and thus led to a more fair and even distribution of the assets amongst the populace. These states also developed new effective legal frameworks and regulatory bodies that guarded against the excesses of markets but still allowed for diversity and competition. It has not been perfect, and no country has gotten every step of the transition right, but the broader successes of fledgling market economies appears to point educators and the politicians who regulate them in the right direction.
Key Lessons

Taking these experiences into account yields several specific lessons for those hoping to transition the American education system from monopoly to market. In brief, they are a set of necessary conditions for transition: the system must *develop a pricing framework*, it must *develop regulations for a market, not a monopoly*, it must *develop financial instruments for new endeavors*, and it must *train new teachers and leaders for these enterprises*.

1. *Must develop a pricing framework*

When the Soviet Union collapsed, the prices of basic goods—bread, heating oil, milk—swung wildly as cost and price came into closer alignment. Because the government had been subsidizing some of the costs of production and setting requirements as to what the goods should cost at retail, no one knew what a loaf of bread, a liter of oil, or a gallon of milk should cost. Once the market was allowed to mature, these fluctuations leveled out. Now, at least in places where the government stays mostly out of the subsidy game, the only times when prices fluctuate is when real changes in cost like decreased supply or demand occur.

In many ways, attempting to price a product like a 4th grader’s education is a much more complicated process than pricing a loaf of bread. But, at the same time, pricing a loaf of bread is not easy! The price reflects its component parts, often procured from vastly different areas and through complex processes of growing and milling, combining them in a bakery, and transporting them to the store. Every bit of that process, from the cost of the fertilizer for the wheat to the gas in the delivery van to the shrink wrap around the loaf is captured in its price.
Accurately pricing an education would require schools to have a much firmer grasp on the component costs of providing an education. Human capital is the largest chunk of any school’s budget, and there is little sensitivity to supply and demand in pricing teacher salaries. Additionally, many schools are staffed and organized in particular configuration due to current monopoly-governing regulations. Specifications for class sizes, instructional days, “seat time” requirements, and school calendars set rigid requirements for exactly how schools should be operated. With innovations in technology, staffing design, and competency-based education models, schools do not have to be organized in these traditional ways and could be made more efficient and less expensive. The Carpe Diem Public Charter Schools in Arizona report spending only $5,300 per student per year (about two-thirds of the Arizona state average) to provide an education that is a hybrid of in-person and computer-driven instruction. In 2010, their Yuma campus ranked first in their country on standardized test scores, including 100 percent of their sixth graders passing the Arizona state standardized test (the AIMS).\(^{25}\) Competing on price should drive more organizations to try to become more efficient and more effective.

It is next to impossible to drive these efficiencies by command: The price mechanism is key to promoting them. Today, with whole-student funding mechanisms like vouchers, tax credits, or charter school allotments, schools compete on quality, but they do not compete on price. There is no incentive for schools not to charge the full amount of the voucher. If they did not, they would be leaving money on the table. If parents have a fungible account of money that can be apportioned between different providers and can be saved if not all of it is utilized, schools will have to compete on quality \textit{and} price. This promotes efficiency, encourages innovation, and develops a more accurate measure of what it costs to educate a student.
2. *Must develop regulations for a market, not a monopoly*

A common political compromise for the passage or expansion of school voucher bills across the country has been the agreement that schools accepting voucher students will participate in the same testing regime as traditional public and public charter schools. While perhaps politically necessary, the lessons of market creation leads us to conclude that this is ultimately unwise. Current school and teacher evaluation systems are designed to regulate a monopoly. Because students have traditionally had very little say in where they go to school, state bureaucracies developed a mandate to do their best to ensure that the schools were of sufficient quality.

But what does it look like to move to an education system that regulates a marketplace? Education is an experience good—a product whose quality is only known once it is consumed. Unlike a loaf of bread, which can simply be thrown out at little cost to the individual, if a child gets a few days into a school year and then realized that a school is not going to meet his or her needs, the cost is real and significant. Economists Eric Hanushek, John Kain, and Steven Rivkin found significant decreases in student achievement for students that switch schools and for students in schools that see large amounts of student turnover. Therefore, the types of regulations needed to manage a school marketplace would be like those for other experience goods with serious transaction costs, like homes or automobiles.

Homes have building codes that they must meet in order to be considered habitable. Automobiles have standards for bumpers, airbags, seatbelts, and other safety measures to make sure they are safe. A one bedroom house can pass inspection just as much as a 50 room mansion. A 3 cylinder Geo Metro can pass inspection just as much as a V8 Mustang. The
essential purpose of these regulations is not to narrow the set of options that consumers have, but rather to ensure that consumers are not placed at risk.

Regulations also ensure accurate labeling. From food labeling to restaurant inspections posted in plain sights, regulations require producers to inform consumers about what they are purchasing. Again, a 1,400 calorie cheeseburger (accurately labeled) can just as easily be purchased as a granola bar (also accurately labeled). Regulations simply let the consumer know what he or she is getting into.

Such could be the same with the regulation of schooling. Rather than attempting to foist one particular set of expectations of schools onto the market, regulators could focus providing the kinds of floors Friedman discussed back in the 1950s, and then allow quality options to flourish. By requiring accurate labeling, that is a set of indicators (which could also be developed in conjunction with accreditors) that would be made available to parents before they make their choices, regulators could work to help make the market work better.

3. Must develop instruments to finance new endeavors

Even in the “coupon”-like arrangements of existing voucher programs, most voucher programs apportion funding for the marginal expense of adding additional students to existing schools, not for the costs associated with starting new schools. Let’s take an example from the nation’s most ambitious voucher program, the Indiana Choice Scholarship. Launched in 2011, the program was the first large-scale, statewide voucher program that had broad enough income-eligibility as to reach well into the middle class (families earning up to 200 percent of the Free and Reduced Lunch threshold, or $85,000 for a family of four, qualified). For grades 1–8, the maximum
amount of voucher is $4,500.\textsuperscript{28} In a classroom of 25 students, if every student has a voucher, there is $112,500 in revenue. A teacher with salary of $50,000 and a fringe benefit rate of 18 percent (a rough average for private school teachers\textsuperscript{29}) has the teacher alone taking up $59,000 of those dollars. If a school has 1 administrator (principal, vice principal, counselor, resource teacher, and so on) for every 100 students making the same as the teacher, they lose another $14,750 of the revenue. The remaining $38,750 is divided amongst other staff (janitors, cafeteria workers, teachers for music, art, and gym classes) and capital costs (technology, heating and cooling and upkeep of buildings, books, desks, lockers, and the rest). It is hard to see any room in those numbers to pay down debts, save for a rainy day, or expand to reach more students.

Nowhere in that funding stream is room to build new buildings or significantly expand existing space to accommodate more students. Government and business need to develop new financial instruments in order to help schools build facilities or upgrade their technological infrastructure to handle more students. Traditionally, public school capital expenses have been funded through bonds or specific line items in state and district budgets. These expenses are accounted separately from the “instructional” expenses of a school. Such funding streams need to be made available to schools participating in choice programs to be able to fund capital expenses.

Financing also requires stability. Even if public capital or start-up funds are not made available and schools want to find ways to finance their own noninstructional expenses, they need to be able to convince lenders that they are going to be able to repay their loans. Unfortunately, as Andrew Neumann demonstrates, many school choice programs fluctuate in their funding or enrollment criteria year to year, causing instability in enrollment and revenue for schools.\textsuperscript{30} This makes securing a loan all the more difficult. If states could ensure more reliable
funding streams for schools that wish to participating, schools would have a much easier time securing loans.

4. **Must train new leaders**

In my colleague Rick Hess’s volume *Cage-Busting Leadership*, he describes the problems of the contemporary school leader:

> Since [the Progressive Era], K-12’s routines and rules have been largely preserved, as if in amber. Intrusive regulation, petty bureaucracy, and balky decision making have bizarrely come to be treated as part of the school house culture.

Going on, he argues:

> As successive generations of entrepreneurs and thinkers in other sectors have revisited basic assumptions and built wholly new organizations, educational leadership preparation has clung to aged norms. Indeed, those championing more flexible, creative, and quality- and cost-conscious leadership have been pilloried for pursuing “corporate-style reform” or labeled “enemies” of public education.31

Current school leaders are trapped in a “cage” of bureaucracy and compliance. Reams of paperwork must be completed to satisfy various local, state, and federal mandates. Multi-hundred page collective bargaining agreements must be navigated. Laws regarding suspensions and expulsion of students must be followed or risk serious lawsuits.

> Clearly, the individual that succeeds in this world is most likely different than the leader of an entrepreneurial school. Rather than spend time completing paperwork, that leader would need to spend his or her time as an instructional leader ensuring an educational program of high enough quality to entice students and the voucher dollars that come with them. The leader will also need to work recruiting students and communicating effectively with parents so as not to lose “customers.” While there might not be collective bargaining agreements, recruiting teachers
from a market-based perspective (that is, paying teachers differently based on labor market demand and performance) would be an extremely onerous task. Complying with funding requirements from the voucher, tax credit, or education savings account programs would also require accounting and legal skills that are simply not necessary today.

As a result, these new schools will need new leaders. According to a 2007 analysis of 210 syllabi from 56 education leadership programs (totaling 2,424 course weeks), Rick Hess and Andrew Kelly found only 2 percent of course weeks address accountability, less than 5 percent cover school improvement via data, technology or empirical research, and only 12 of the 360 course weeks devoted to personnel management reference teacher dismissal and nine mentioned teacher compensation.32

New, entrepreneurial school leaders will need to be prepared either by existing preparation programs housed in colleges and universities or by new programs that have yet to be created. They will need to be trained not only in instructional leadership but marketing, accounting, law, and human resources management. This will require preparation programs to leave the comfortable silos that have developed in colleges of education and bring outside expertise to help train leaders.

One example of such a training program is the Rice Education Entrepreneurship Program (REEP) at Rice University. Housed in Rice’s business school, not a school of education, REEP offers an MBA for school leaders as well as a business fellowship and summer institute that work to bring different voices on effective management together in one place. Both the MBA and business fellowship can grant a Principal Certificate for the State of Texas. This type of outside-the-box program that broadens the set of tools at the disposal of school leaders is a model
for the preparation programs needed for the entrepreneurial leaders of schools in choice programs.\textsuperscript{33}

\textbf{Cautions}

As even a cursory reading of the history of market transition will yield, moving from government monopoly to private enterprise is rocky, and does not always work out as planned. A survey of that history yields three important lessons when we think about applying market creation to education.

\textit{Unemployment}

There’s an old joke about working in a Communist system:

\begin{quote}
Three workers find themselves locked up, and they ask each other what they’re in for. The first man says: “I was always ten minutes late to work, so I was accused of sabotage.” The second man says: “I was always ten minutes early to work, so I was accused of espionage.” The third man says: “I always got to work on time, so I was accused of having a Western watch.”
\end{quote}

While bureaucrats in the large government-run monopolies of communist states had to become quite adept at navigating the byzantine set of regulations and politics that governed life in communist societies, people had work to do and were paid for it. When these large bureaucracies were broken up and replaced with private companies, while they perhaps might
not worry about being sent to a gulag for having a functioning watch, workers did have to worry about losing their job.

Under communism, there was really no such thing as “unemployment.” The Czech Republic, for example, employed 99.7 percent of the working population in state-owned enterprises. By the mid 1990s though, unemployment rose to 16 percent in Poland, 12 percent in Hungary, and 14 percent in Romania and Ukraine. Polling data from that time saw the effect of unemployment on citizens’ outlook on the transition as a whole. Only 12 percent of Hungarians, 18 percent of Poles, and 32 percent of Czechs thought that they were better off post-transition as opposed to immediately before. As a result, both Poles and Hungarians returned ex-Communist parties to power in the early 1990s.

If we think that schools are not operated efficiently today, or are not selecting or retaining the best people as teachers due to collective bargaining or outdated human capital processes, we can expect this movement from monopoly to market to lead to the unemployment of thousands of teachers. If we believe that Poland-level 16 percent unemployment could be expected for the 3.3 million teachers in America, we are looking at the loss or displacement of over half a million middle-class workers. That portends serious problems.

First, this could undermine support for reforms. Like the Poles and Hungarians that wavered in early years, supporters of market control that saw this much disruption could fall back to supporting politicians that wished to return to the less productive but more stable organization of schools we have today. But second, and more importantly, this would negatively impact the lives of hundreds of thousands of people, who have specialized skills that might not necessarily have great labor market prospects.
To blunt the spread of Communism in the 1940s and 1950s the American government had the Marshall Plan; perhaps one is necessary for education. The Marshall Plan provided funds to purchase food and goods necessary for the displaced people of war torn Europe, but perhaps more importantly offered technical assistance to European countries to modernize their economies to become more productive and support themselves. In communities where schools are closed or for individuals that lose their jobs, such assistance could be helpful to provide new social capital and job skills for those affected.

_Creative Destruction Involves Destroying Things_

Markets are based on what Joseph Schumpeter termed “creative destruction.” Markets privilege organizations that are best suited to meet the needs of consumers and encourage capital and consumers to move from less productive organizations to more productive organizations. Over time, less productive organizations shutter and more productive organizations grow, but it happens in fits and starts and can be disruptive in the near term. A market-based system would see more creation of new schools and shuttering of old schools than our current system. This would be a marked departure.

Today, schools are closed in a more “democratic” than market based fashion. Let’s take the example of Kansas City. In the late 1990s the Kansas City schools enrolled over 35,000 students. By 2010, due to an increasing charter presence, flight from the urban core, and the annexation of swaths of the district by neighboring districts, only 17,000 students actually attended school in the Kansas City Public Schools district. As a result, elementary schools sat, on average, 40 percent empty. It was worse in middle schools, which were 60 percent empty,
and even worse in high schools. To deal with these problems, then Superintendent John Covington proposed closing 26 of the 63 schools in the city.

How were these schools selected? As documented by Mary Essleman, Rebecca Lee-Gwin, and Michael Rounds in education magazine *Phi Delta Kappan*, Covington created a community task force which held multiple public forums. District officials created scorecards for each school that rated schools on 52 separate indicators from academic performance to building conditions and infrastructure to enrollment. After these results came out, the task force held an additional round of public meetings to discuss grade-level organization, issues of gang territory, and attendance boundaries for new schools should particular schools close. Covington and his team used this input, as well as the scorecards to pick which schools should close and which should stay open.

Markets do not work like that. If a school cannot recruit enough families, it will close, regardless of how that affects the neighborhood, how nice the building was, or whether that means that students will have to traverse unfriendly territory to attend a new school. As a result, individuals’ lives are disrupted, and this needs to be taken into account.

There are several possible policies that might help mitigate the disruption of closing schools. First, enrollment lotteries for schools could be weighted so as to keep families or children from the same neighborhood together. Second, cities could make sure to target outreach to communities losing schools, working with local churches or other civic organizations to provide meeting spaces, recreational activities, park space, and playgrounds for communities that lose schools. Also, bonus funding could be made available for schools that purposefully locate in areas that have had schools leave.
Winner and Losers Are Not Who You Think They Are

Usually when one thinks about who might “win” and who might “lose” in a school choice system, the default idea is that those who get to participate in a charter school, school voucher, tax credit, or education savings account program are the “winners” and those who are left behind in public schools are the losers. I do not think this is the right way to think about the issue. Under the theory of school choice, the belief is that not only would those students that participate in the program benefit, but so would non-choosing students, as their schools would feel increasing competition and improve so as not to lose students. Research bears out this theory. In a 2013 review of the literature on the competitive effects of private school choice, Greg Forster compiled the 23 studies of the topic to date. Twenty-two found positive effects for those students who remained in public schools and only one found no significant effect. 41

Markets rely on the winnowing process of creative destruction, which relies on some people making good decisions, and some people making bad decisions. Automobiles today are better because some consumers bought Edsels in the 1950s, Corvairs in the 1960s, Chevettes in the 1970s, Yugos in the 1980s, Suzuki Sidekicks in the 1990s, and Pontiac Aztecs in the 2000s. Folks drove those cars (or in some cases just looked and shuddered) and spread the word that they were bad cars, and why. The market learned. Automakers figured out how to make cars more reliable, comfortable, powerful, and less expensive. Unfortunately, that lesson took folks actually sinking their money and years of their lives on these cars. Perhaps saying to them today “due to what we learned from you, we have improved cars a lot” is little solace. But, the odds that the next car those people bought was better.
This is a difficult concept for many of those who believe in reforming education to stomach, and for good reason. We are not just talking about losing a couple of thousand dollars on a bad car, we are talking about children’s’ lives.

The lesson from market creation is not that it is a panacea for all social and economic problems. Rather, it creates a situation where innovation and excellence are encouraged and rewarded and capital moves, at time slowly and imperfectly, from less productive enterprises to more productive enterprises. It is not something that happens over night. It took countries and the industries within them decades to fill with appropriately-skilled employees and managers, for politicians to create legal frameworks to allow for property rights and financing, and for disequilibria to stabilize. But, the movement has almost exclusively been in one direction, from monopoly to market, and there is a reason for that.

A Closing Thought

Making markets work involves managing transition. Markets, as our brothers and sisters around the world have learned, do not simply emerge from the ether. Birthing a new system of organization and management is difficult, costly, and onerous. It is also not guaranteed to succeed. The choices that policymakers make to foster new markets, guard against corruption, and help those negatively affected by market forces will ultimately determine if the endeavor succeeds or fails.
Draft: Do not cite without permission from the author.

7 Ibid.
14 Presented elsewhere in this series.
16 Hanoushek, Kocena, and Svejnar: 76.
17 Hanoushek, Kocena, and Svejnar: 77.
18 Hanoushek, Kocena, and Svejnar: 78.
19 Hanoushek, Kocena, and Svejnar: 79.
20 Hanoushek, Kocena, and Svejnar: 79.
30 Elsewhere in this series.
36 Ibid.
37 Ibid.