



SNAPSHOT

- ❶ When judged against the criteria for a genuine free market, existing education choice and competition appear more akin to glasnost and perestroika – manipulation of state monopoly provision.

- ❷ School choice and competition have the potential significantly to increase educational achievement, but the design of the system is immensely important. With only marginal increases in competitive behaviour one cannot expect large increases in educational achievement.

- ❸ System design must aim to maximise choice, school and competition effects.

- ❹ Competition needs to induce competitive behaviour. Parents must have the ability to choose. Schools must compete by improving standards. Freedom must be accompanied by accountability.

- ❺ Competitive forces, including the profit motive, the free entry and exit of firms and sensible levels of regulation, are crucial.

Glasnost, perestroika and free market schools

Gabriel Sahlgren, winner of the Institute of Economic Affairs' Hayek Prize, analyses the challenges to genuine choice and competition in schools.

In November 2011, the IoD began a major study into the impact of school choice and competition. The motivation for this study was a belief that in the 21st century public opinion will force far greater choice and competition in that most important area of our lives, our children's future. Faced with a multitude of choices up and down the high street, parents are not expected to remain wedded to state monopoly provision in schooling.

The first stage of the project, summarised here, was to construct a theoretical framework for analysing choice and competition in schooling. The second stage constitutes a comprehensive review of the academic literature in this area from around the world. The third stage reviews the impact of choice and competition in the UK. The final stage develops a future model for education choice and competition in the UK, based on the domestic and international evidence.

The final report, covering all the analysis in each of the four stages, will be published by Gabriel Sahlgren and the IoD's Graeme Leach in April 2012.

HOW COMPETITION MIGHT INCREASE EDUCATIONAL ATTAINMENT

While market education, in one form or another, dates back to Athens in the fifth century BC, the idea of injecting competition into publicly funded education systems is normally attributed to Milton Friedman in the 1950s.¹ Separating the funding and provision of education, Friedman proposed that government would be restricted to issuing education vouchers to parents/pupils who would pick the school, private or public, of their choosing. By allowing school choice, a competitive market in education would develop. Rather than only being within reach of high-income families – who can move houses in order to get their children into the publicly-funded school of their choice, or simply send them to fee-paying private schools – a true school choice

¹ M. Friedman, "The Role of Government in Education", in Robert A. Solo (ed.), *Economics and the Public Interest*, Rutgers University Press, 1955.

programme would enable pupils from all classes to participate.

There are several mechanisms involved in school choice and competition that could potentially lead to increasing educational achievement. First, allowing pupils/parents to choose the school they prefer may allow a better match between pupil and school, in stark contrast to the top-down, one-size-fits-all approach that often characterises government schooling. The outcome of this improved match, which can be termed ‘choice effects’, should presumably be improved achievement. The corollary is that few restrictions should be put on schools, since these would hamper providers’ ability to respond to local and individual needs.

Second, and related to the first mechanism, it might be the case that private schools are simply better than publicly-operated ones. This could be because they: (1) are more autonomous, being able to respond better to pupils’ needs; (2) are more strongly incentivised to innovate and decrease costs; and (3) can resist teacher unions’ attempts to favour their members’ interests at the expense of pupils’ education. If this is the case, the reallocation of pupils from publicly-funded schools to private schools should increase achievement by itself. The improvements in attainment that occur as a result can be termed ‘school effects’.

Third, and perhaps most important, parental/pupil choice generates competition between schools. When choice is allowed, schools must respond by competing to attract pupils. Assuming that markets are generally better than monopolies in allocating resources, this scenario presumes that competition will result in either: (1) a reallocation of pupils from failing schools to successful ones; or (2) improvements in failing schools. The result would be ‘competition effects’ that improve achievement for all pupils. If the second scenario is realised, competition would ensure that publicly-funded schools behave more like private schools. Yet, if the first scenario is correct, one would expect publicly-funded schools gradually to disappear as they are outcompeted. It could be the case that publicly-funded schools, simply for the reason of being publicly owned, cannot be as responsive to incentives as private schools. If so, one would expect private schools to crowd out publicly-funded ones by virtue of being more efficient.

But there is an important theoretical discrepancy in the argument for school competition. This is because economic theory also suggests that larger schools can capitalise on economies of scale. Assuming a fixed market size, more competitors should lead to smaller schools. This implies a trade-off between competition and scale economies that has received scant attention in the school choice literature. This paper argues that this has strong implications for the preferred ownership structure of schools: while non-profit and publicly-funded schools have few incentives to scale up significantly, for-profit chain schools, due to the profit motive, have strong incentives to increase in size and the number of locations in order to replicate success. This suggests that for-profit chain schools, and incentives to encourage these to expand, could be instrumental in bridging the theoretical trade-off between scale economies and school competition.

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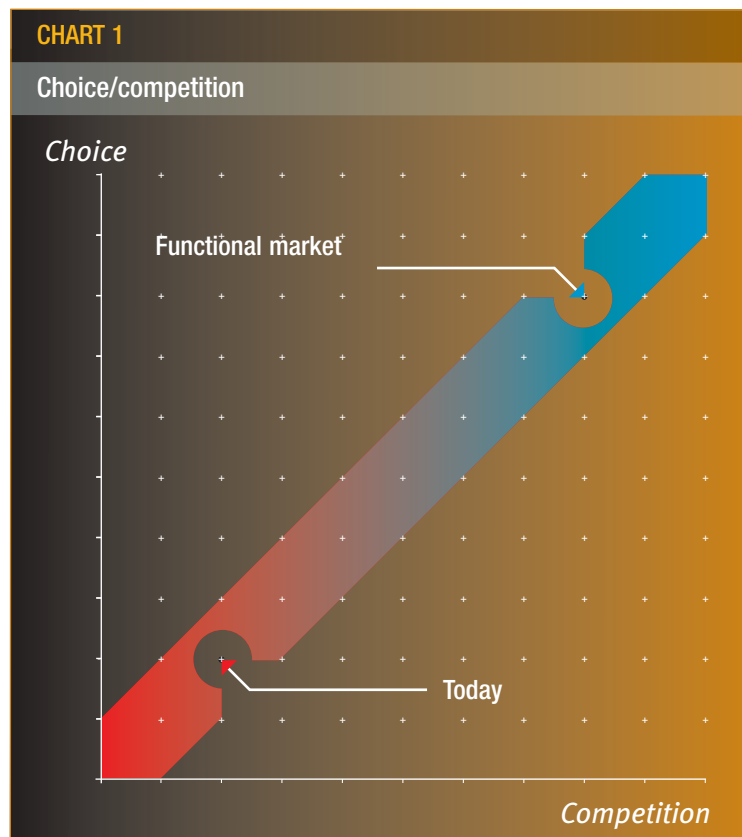
THE THEORY IN PRACTICE

Having broadly outlined the theoretical mechanisms supposed to link school choice with increased educational attainment, it is extremely important to note that the beneficial effects depend strongly on four core assumptions: (1) that the nature of competition actually induces

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competitive behaviour; (2) that parents have the ability to choose, and in reality do choose, schools they believe will increase their children’s educational attainment; (3) that schools compete by increasing standards; and (4) that freedom is accompanied by accountability to ensure the other conditions are met. If this is not the case, there is little reason to believe that competition would improve educational attainment significantly. In fact, it might even lead to a deterioration in attainment.

One cannot test the hypothesis that competition among schools will raise productivity by looking at choice reforms that fail to introduce competitive incentives. With no, or only marginal, increases in competitive behaviour, one cannot expect large improvements in educational achievement. This point should be obvious, but is too often neglected. Most of what we have learned about school choice is based on evidence drawn from two sectors – religious institutions and publicly-funded education – in which the key actors and decision criteria are distinctly not market-driven in the conventional sense. There is a limit to what we can conclude from competition among such organisations. School choice in the publicly-funded sector is essentially competition without competing firms owning different parts of the means of production, and may thus be more accurately described as ‘market socialism’ – rendering its prospects to increase educational attainment rather bleak. This is important since there is often little relation between the degree of structural measures of competition commonly used in studies evaluating public school choice reforms, such as the number of schools in the same area, and perceived competition – suggesting that competitive incentives do not necessarily increase with structural competition. Similarly, non-profit organisations, such as churches, are not necessarily expected to engage in extensive competitive behaviour, which in sectors with for-profit producers has generated radical innovation.



BUILDING AN EFFECTIVE COMPETITIVE SYSTEM

Quantity versus quality

Apart from differentiating the nature of competition in terms of intensity and ownership structures of schools, it is also important to separate competition quality and quantity. Indeed, there is often little relationship between measures of perceived intensity of competition and the number of perceived competitors, suggesting that headteachers' perceptions of competitive behaviour emanate from other factors than the number of perceived competitors. Competitive incentives are likely to be stronger if competitors are doing well. It is highly likely, therefore, that the impact of competition also depends on its quality, or, in other words, how schools' competitors perform. This has strong implications for many studies evaluating school choice programmes, since the great majority measure competition solely by quantitative gauges.

Free entry and exit

Equally importantly, for the potential of competition to be realised, failing schools – whether private or publicly-funded – must go bust in classic 'creative destruction' processes.² Some schools will be outperformed and, if pupils do not leave failing schools, they will not benefit from school choice, rendering it unlikely to result in increasing educational attainment. The advantage of choice is precisely that pupils can migrate from poor schools to good ones, making it necessary that this actually occurs. Similarly, in order to maximise efficiency, successful schools should have incentives to scale up in order to replicate their success; just as in any other market, winning organisations should expand to satisfy demand. In the education market, this means that education providers should grow by increasing their pupil rolls and opening new schools. It would be especially advantageous if such organisations expanded in new markets, thus serving an increasing number of communities and pupils while benefiting from scale economies. As argued above, only for-profit schools have strong incentives to do so. The scope and nature of competition, therefore, are clearly key in deciding whether or not school competition will successfully raise achievement.

Parental choice

Further, it is vital that: (1) parents choose schools on the basis of how good they are at improving their children's educational attainment; and (2) that parents know how to exercise this choice in accordance with their preferences. If parents select schools on the basis of their academic quality, then schools would compete for students on that basis; if parents value religious education or sports, then one would expect to see schools respond accordingly. If we are particularly interested in increasing educational attainment, then, any school choice system should incentivise parents to choose schools based on academic quality. This is especially important for ensuring that pupils from all socio-economic backgrounds benefit from choice, since parents from poorer backgrounds may be less likely to put value on academic achievements – as they might expect education to yield lower returns for their children – or find it more costly to act upon their preferences, meaning they would be less inclined to search for high-quality information about schools. A programme that does not ensure that parents base their choice of school on academic ability or does not provide access to high-quality information with which to assess alternatives, is not likely to function well.

² Joseph A. Schumpeter, *Capitalism, Socialism & Democracy*, 1976.

Minimising ‘cream skimming’

Schools must also be induced to compete by raising quality. For example, schools could engage solely in ‘cream skimming’ – simply selecting better pupils to boost their average test scores. If this is the case, one should not expect the total level of educational quality to increase, rather that quality would simply be redistributed among schools. In fact, given that peer effects may be important determinants of educational attainment, if cream skimming were sufficiently severe one could expect overall negative effects. There is no reason why cream skimming is a necessary outcome of school choice and any successful programme must be designed to minimise it so as to ensure that schools compete in terms of quality.

Balancing freedom and accountability

Finally, it is necessary to balance freedom with accountability. Regulations ensuring appropriate incentive structures should be in place when implementing market education reforms. There is of course always a fine balance between holding schools accountable to centrally-set goals and affording the freedom to innovate and specialise. If accountability to centralised regulation is too strict, there is little reason to believe that significant innovation and improvements would ensue from competition. For a true transformation to take place, as in other markets, innovation and experimentation are vital. This means that we might be forced to abandon many preconceptions of how education should be carried out. As Friedman put it, “No one can predict in advance the direction that a truly free-market educational system would take.”³ If we impose overly cumbersome regulation, a true revolution in education might be stifled.

At the same time, completely relinquishing control means that we open the door to potential market failures. In a world of near-perfect information and low transaction costs, radical freedom of choice may be sufficient to provide the competitive incentives necessary to ensure that failing schools go bust and good ones expand. Education markets rarely come close to such a perfect world. It could be argued, of course, that in the long run market imperfections would be eradicated by the sheer force of entrepreneurship and innovation.⁴ The question, however, is how long is long enough? Although perhaps correct, arguments based on future innovation are difficult rigorously to assess empirically.

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DESIGN MATTERS

The clear conclusion of this theoretical framework is that school choice and competition have the potential significantly to increase educational achievement, but that system design is immensely important. School choice systems that do not adequately take into account the above concerns are not likely to improve educational attainment significantly.

³ Milton Friedman, *Public schools: Make them private*, Education Economics 5 (3), 1997.

⁴ Schumpeter’s (1976) theory about capitalist innovation through a process of ‘creative destruction’ and other theories emanating from economists working within the Austrian tradition.