

**IS PRIVATIZATION MORE EFFICIENT? THE CASE OF EDUCATION  
ALTERNATIVES INC. IN BALTIMORE**

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# **Is Privatization More Efficient? The Case of Education Alternatives Inc. in Baltimore**

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## **Abstract**

Privatization of management services is relatively new in the field of public education in the United States. As of yet, only one competitor has entered the market to provide such services. Education Alternatives Inc. of Minneapolis, MN has provided limited services for schools in Minnesota, Michigan and Florida and in 1992 received its first large-scale management contract for nine public schools in Baltimore, MD. This study provides an in-depth analysis of EAI's contract with the Baltimore Public Schools and EAI's spending practices in the nine schools under its management. The findings suggest that EAI received per pupil allocations in excess of district averages. It is also shown that EAI's spending practices differed significantly both from other schools in the district and by comparison with previous spending practices in the schools under EAI management. It is suggested that these findings be taken into consideration by both school districts and private providers in their pursuit of future endeavors.

## **1.0 Introduction**

In recent years, competitive markets have played an increasing role in public education. Attempts to introduce free market strategies into the realm of public education have ranged from models of school choice, to an increasing number of private providers of services to educational institutions. Where these services were once limited to private contracts with operations and maintenance firms or transportation services, recent efforts have been made to broaden the role of private providers in education. With criticism of economic efficiency and lack of confidence in current instructional practices reaching a pinnacle, private providers have begun try their hand at larger scale endeavors such as managing or providing educational services for schools or entire districts.

The most commonly stated objective of those who contract private providers is to achieve cost-effectiveness in providing the specified services. Cost-effectiveness cannot

be determined solely as a measure of inputs or outcomes. Rather, it must be assessed as a measure of the relationship between inputs and outcomes. The view of cost-effectiveness from the perspective of the organization hiring a private contractor may be reduced to 1) the contractor provides the same, or more service for less cost or 2) the contractor provides a higher quality of service for the same or less cost. At the same time, the central economic motivation for the private, for-profit company that is contracting their services is to seek profits. The outcomes of this motivation, however, are not always obvious, frequently yielding an equal number of positive and negative results. In education, we continue to lack the relevant experience to anticipate these outcomes and assess effectiveness. As a result, we must look to other fields such as health care for advisement.

### 1.1 Pros and Cons of Privatization in Education

It was similarly believed in the field of health care that privatization would induce competition between HMOs which would ultimately lead to a decline in the cost, thereby an increase in accessibility of services. The experiment of large scale privatization in health care has revealed many of the cons of privatization that need to be addressed in conjunction with the pros as we consider the expansion of privatization in education. Our experience with HMOs emphasizes the need to assess the effect of the profit motive on the quality of services. Those in favor of privatization contend that private providers have the profit incentive driving their desire to be more cost-effective while those opposed contend that the desire to seek profit may lead to decreased spending on services and adversely affect the ability to provide adequate services.

These particular views are based on the effect of the profit motive on spending practices, but the profit motive also plays a significant role in an organization's approach to revenue generating activities. Private organizations generally seek to earn greater returns to investment than public organizations. While this practice may result in more effective cash flow management, it is equally likely to lead to increased risk taking on investments. The freedom to take these risks is yet another pro/con of privatization. Most publicly held funds may not be put at risk to same extent as privately held assets. The issue becomes significantly muddied when private, for-profit, organizations gain control over public funds.

Perhaps the most significant argument in favor of the private provider is that they can more easily be performance contracted. Ultimately, the performance contract allows the consumer to choose whether to continue purchasing the services of the provider. A recent study from the NYC public advocate's office pointed out that the profit motive in health care management has resulted in some highly rated service oriented HMOs as well as low rated, apparently profit oriented HMOs. It should be expected, that those HMOs that received low service ratings will either suffer the economic consequences, or modify their practices. The entrance of more providers into the educational market-place should lead to similar competitive adaptation or selection.

### 1.2 The Need for Empirical Research

As of yet, only one competitor in the market has established a track record, and the data is limited at best. In the Fall of 1992, Education Alternatives Inc.(EAI) of Minneapolis, MN established their first major management contract with the Baltimore

City Public Schools. The contract specified that EAI would assume responsibility for the financial and educational management of nine Baltimore schools, eight elementary schools and one middle school. Subsequent to the Baltimore contract, EAI established its first entire district contract with the Hartford, CT public schools in the Fall of 1994. By the Winter of 1995, however, amidst political turmoil and ambiguous results, both contracts had been discontinued.

Although EAI's major contract efforts have failed, other competitors have begun to enter the field. In the Fall of 1995, The Edison Project, under CEO Benno C. Schmidt, Jr. Announced the opening of their first four *Edison Partnership Schools*. Edison's strategy is distinctly different from that of EAI in that they have chosen to focus on individual schools, rather than entire districts, and in one case, opted to run a charter school.<sup>1</sup> In addition, Edison professes to provide educational, rather than management services. Unfortunately, Edison's experiences to date are insignificant in providing additional insights into the future of the education market.

In order to improve the public understanding of ventures of this kind, this study presents an in-depth analysis of Education Alternatives' experiences in Baltimore, Maryland. From the Fall of 1992 through the termination of their contract in the Fall of 1995, EAI's TESSERACT project in Baltimore continues to be the most significant venture of its kind. It is our belief that EAI's experiences, both positive and negative, will provide valuable insights for both vendors and consumers in pursuing future ventures in the education market.

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<sup>1</sup> Renaissance Charter School, Boston, MA

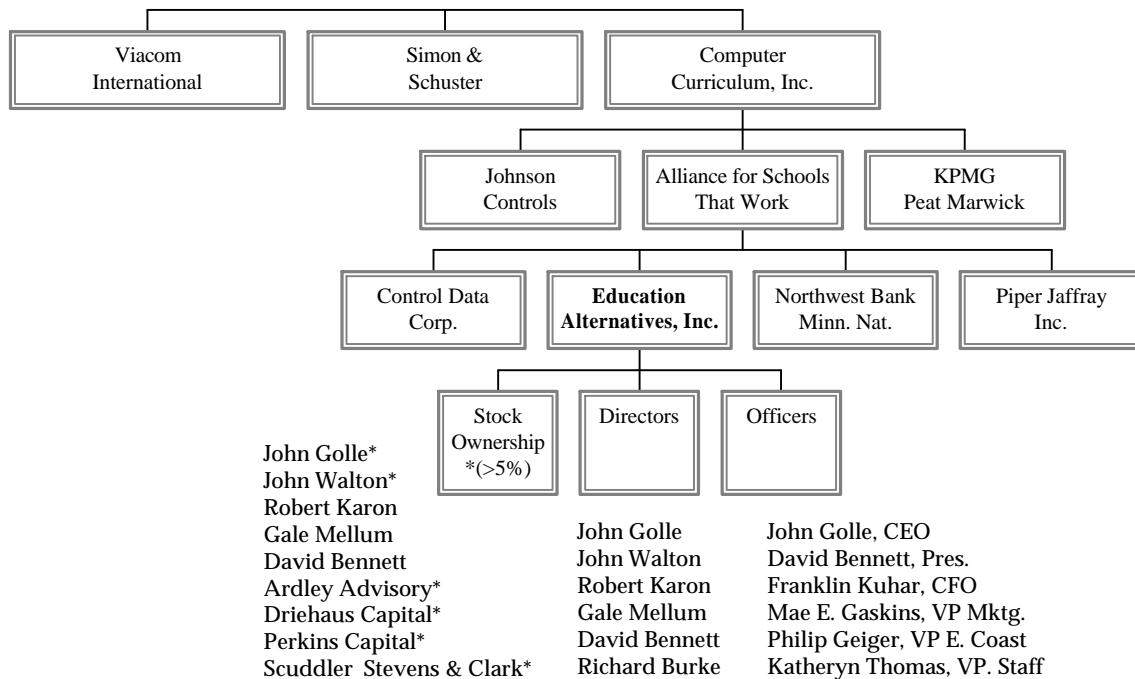
## **2.0 Background**

### 2.1 Profile of EAI

EAI was originally part of a Control Data corporation subsidiary, USSA Private Schools Inc. CDC had created USSA Private Schools in an attempt to penetrate the primary and secondary education computer market, but due to financial difficulties in the 1980s, CDC was forced to divest 22 businesses, including the sale of USSA private schools to John Golle (Richards, 1995). According to EAI's 1994 Annual report, the company delivers its services in three ways: managing schools, providing consulting services, and distributing proprietary products. As of the time of this study, EAI held management contracts with Hartford, CT, Baltimore, MD; management agreements with Eagan, MN and paradise valley, AR; and consulting contracts with additional public schools in Baltimore. EAI lost its contract with Dade County florida after a study revealed that EAI's previous efforts in South Point, MI had yeilded significantly better results.

EAI participates in what it calls the *Alliance for Schools that Work*. In addition to EAI, the Alliance includes KPMG Peat Marwick, a major financial accounting firm, Johnson Controls-Facility Management Services, a firm that specializes in facilities maintenance, energy use, transportation and other non-instructional services for schools, and Computer Curriculum Corporation, a unit of Simon and Schuster. Figure A displays the corporate alliances and roots of Education Alternatives.

Figure A: Corporate structure and alliances of Education Alternatives Inc.



## 2.2 EAI's Revenue Sources

EAI generates revenue from three sources; operations, investment and the sale of stock. Table 1 displays EAI's net earnings from 1990 through 1994. Through 1994, EAI had yet to make a profit running schools. EAI has had mixed success with investments. With a low of -37.6% in 1991 and a high of 7.3% in 1994, EAI's return on assets over the period studied never topped the performance of a treasury bond (Richards, Shore & Sawicky, 1996). EAI suffered substantial losses in 1994<sup>2</sup> at the hands of Worth Bruntjen of Piper Jaffray. During their period of rapid growth, between the Fall of 1992 and 1993, EAI was more successful at issuing stock than at any of its other competencies: It raised \$5.6 million in the IPO at \$4/share; \$1.9 million in June of 1992 at \$7/share and \$31.1 million in May, 1993, at \$22.25/share.

<sup>2</sup> two thirds of an initial investment of over \$2 million

Table 1: EAI's net earnings (loss) from 1990 through 1994.

| <b>Year</b>           | <b>1990</b> | <b>1991</b> | <b>1992</b> | <b>1993</b> | <b>1994</b> |
|-----------------------|-------------|-------------|-------------|-------------|-------------|
| Net Earnings          |             |             |             |             |             |
| (Loss) <i>dollars</i> | (1,672)     | (1,498)     | (1,551)     | 1,119       | 2,534       |
| <i>in 000's</i>       |             |             |             |             |             |

### 2.3 EAI's Stock History

Appendix A displays the life of EAI's stock from its IPO in May of 1991 to present. Among EAI's largest stockholders (See Figure A) are insiders John Golle (9.3%) and John Walton. Somewhat ironically, EAI's thirteenth largest institutional stockholder in 1994 was the NY State Teachers Retirement Fund. From June 26 of 1992 to November 12 of 1993 EAI stock climbed from \$7 per share to \$48 1/2 per share, almost a 7X increase in value over a period of 17 months. This change represented an average growth of \$2.4 per month. This impressive climb seemed to be driven by a series of key events including 1) the formation of the alliance with KPMG Peat Marwick, 2) the purchase of 100,000 shares of EAI stock by John Walton 3) the signing of a contract with the Baltimore Public Schools, 4) speculation of a contract with Milwaukee, WI and 5) reports of substantial test score gains in EAI's TESSERACT school in August of 1993.

Between November 12 of 1993 and April 8 of 1994 EAI stock prices plummeted from \$48 1/2 per share to \$11 per share. This represented a -4.4X decrease over a five month period. The average loss per month for this period was \$7.5 per share. The drop in EAI's stock value seemed to be prefaced by 1) the U.S. Department of Education's confirmation of special education violations in EAI's Baltimore schools and 2) the release



of a report by Howard Schilit of American University alleging revenue inflation by EAI in its stock reports. Both of these events were accompanied by legal action against EAI. In December of 1993 the AFT and the BTU filed a lawsuit against the BCPS alleging special education abuses in EAI schools and in February of 1994, two EAI shareholders filed a lawsuit alleging revenue inflation, having an obvious adverse effect on the price of EAI stock.

Between February of 1994 and February of 1995, EAI's stock prices hovered between \$10 and \$20, exceeding \$20 for a brief period in the fall of 1994 after the signing of the Hartford contract. Despite signing a new major contract, and positive reviews from analysts<sup>3</sup>, the media continued to play an equalizing role, reporting on special education allegations (Baltimore Sun, August 1994) and disclosing information regarding an SBA loan received by EAI at start-up (Minneapolis Star Tribune, August 1994) and EAI's investment in derivatives (Baltimore Sun, August 1994). Interestingly, the quiet dismissal of the shareholder lawsuit in January of 1995 was not a widely reported event. Failure to renew both major contracts in Baltimore and Hartford, CT in the Fall of 1995 sent EAI stock below its IPO in the Spring of 1992. Stock sales were suspended for a period in December and to this date, EAI's stock has not rebounded.

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<sup>3</sup> Mike Moe of Lehman Bros. listed EAI as a "buy"

## 2.4 Overview of EAI's Contract with the BCPS

In the Summer of 1992, when Education Alternatives Inc. assumed responsibility for the management of nine of Baltimore's public schools, the objective of the administration of the Baltimore City Public Schools was to stimulate improved performance in some of the city's most troubled schools while at the same time achieving economic efficiency in the management of the schools. At the outset of the TESSERACT project EAI was allocated a total budget for the nine schools according to the following guidelines. A per pupil allowance was determined relative to the district's total budget and FTE population. A 15% payback was included to cover administrative and support costs provided by the district's central administration. The resulting per pupil allowance was allocated to EAI to generate a total budget of \$23,937,770.

### **Original EAI/TESSERACT Contract:**<sup>4</sup>

|              |                             |
|--------------|-----------------------------|
| \$5,918      | per pupil allowance         |
| - \$888      | (15% "pay back")            |
| \$5,030      | per pupil                   |
| x 4,759      | pupils at 9 EAI-run schools |
| \$23,937,770 | total funds to EAI          |

In March of 1994 the BCPS and EAI modified the contract to reduce the administrative payback to 7.5% resulting in an 8.8% increase (\$2.1 million) in EAI's total budget (after payback).

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<sup>4</sup> Office of the President of the City Council, Mary Pat Clarke

**EAI Formula Modified March 23, 1994:** <sup>5</sup>

\$5,918 per pupil allowance  
- \$444 (7.5% "payback")  
\$5,474 per pupil  
x 4,759 pupils at 9 EAI-run schools  
\$26,050,766 ADJUSTED total funds to EAI

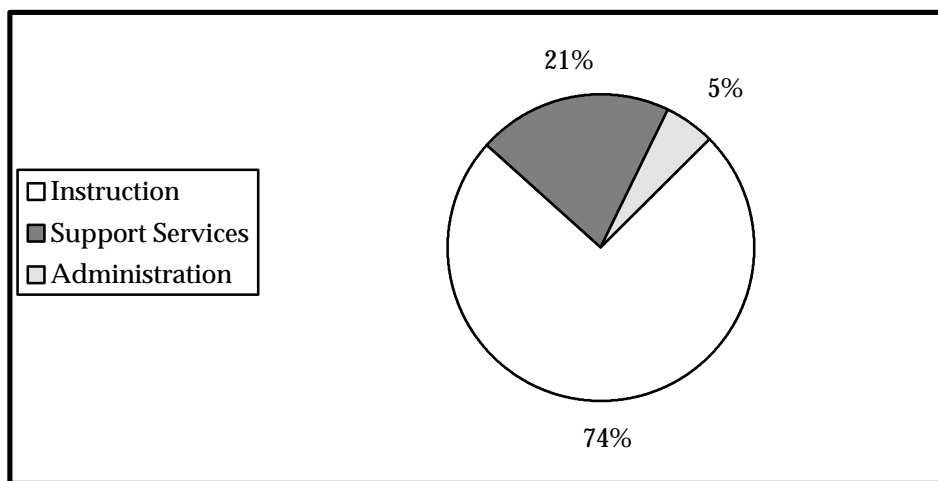
|                    |                         |
|--------------------|-------------------------|
| \$26,050,766       | March 23, 1994 Contract |
| - 23,937,770       | Original EAI Contract   |
| <b>\$2,112,996</b> | <b>Refunded to EAI</b>  |

The original contract for the TESSERACT project was awarded to EAI through a non-competitive bidding process. Economic theory suggests that in the absence of competitive bidding, the only basis that exists for determining cost is the cost history of the organization itself. Given a cursory view of the BCPS budget (See table 2), the source of the original \$5,918 allowance is not readily apparent. It does seem, however to fall between the calculated per pupil expenditure levels of \$5,768 (FY '93) and \$6,061 (FY '94) in Table 2. Adoption of the 15% payback in the original contract and the 7.5% payback in the modified contract seems even more elusive. According the breakout costs represented in Figure B the payback figures appear to represent a composite of administrative and support service costs. Although the payback figures exceed district administrative costs as a percentage of the total budget (5%), they fall well short of the combined total of administrative costs and support services (26%).

Table 2: Summary of BCPS budget totals and enrollments for 1993 and 1994<sup>6</sup>

|                     | <b>Enrollment</b>    | <b>Total Budget</b> | <b>Per Pupil Expenditures (PPE)</b> |
|---------------------|----------------------|---------------------|-------------------------------------|
| FY 1993 (Actual)    | 101,809              | \$587,229,678       | \$5,768                             |
| FY 1994 (Projected) | 101,809 <sup>7</sup> | \$617,083,208       | \$6,061                             |

Figure B: BCPS break-out costs by major budget area (FY 1993)



### 3.0 Methods of Analysis

#### 3.1 The Cost of Education in Baltimore

The inconsistencies present in our cursory comparison of the EAI contract with the BCPS budget overview suggested that we more closely scrutinize the origins of the figures used in the EAI contract. One concern that arose from the inconsistencies was the possibility that the figures used in the EAI contract, and the figures presented in the district budget overview may not accurately reflect the true cost of education in Baltimore. If, in fact, it was the BCPS objective to find a private contractor who could provide their

<sup>5</sup> Office of the President of the City Council, Mary Pat Clarke

<sup>6</sup>1993-1994 Site-based Budgets

schools with better service for the same or less cost, a key element of this study must be the determination of the Baltimore's previous education spending practices. This study presents a data intensive approach to determining the actual cost history of the BCPS. Among the approaches employed were the determination of district-wide spending trends by school type, and direct comparison of EAI schools with similar institutions within the district. Through these analyses, we set out to answer the following questions:

- What are the actual costs of educating students in each of the different types of educational institutions in Baltimore?
- How well do the selected "Comparison Schools" compare with EAI schools regarding per pupil expenditures?
- What savings might the district achieve by using alternative methods for calculating the EAI allowance?

The BCPS budget is distributed among 178 school units, among which are 113 elementary schools, with an average FTE of 479; 25 middle schools with an average FTE of 888; and 18 high schools with an average FTE of 1079. Four schools in the district serve as elementary/middle schools and eleven schools are classified as special facilities. For the purpose of the following analysis, school types have been defined as:

- Elementary Schools K-5 (6)
- Middle Schools 6-8 (9)
- High Schools 9 - 12
- Special Facilities (Primary and Special Education Facilities)

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<sup>7</sup> Previous year FTE used in absence of projected data for FY 1994

As a result of this categorization, some schools within the district, such as elementary/middle schools have been omitted from the analysis. It should be noted, however that per pupil expenditures for these institutions follow quite closely the spending patterns of the defined groups.

### 3.2 How EAI Spent Their Money

To further understand how EAI intended to provide better services to Baltimore students, we attempted to discern how EAI's spending practices differed from, or were similar to, the spending practices of other Baltimore schools, and the previous spending practices in the schools contracted to EAI. For the internal spending analyses, the first objective was to construct parallel budgets for EAI schools and Non-EAI schools in Baltimore. The second objective was to reconstruct the budgets for EAI schools prior and subsequent to EAI management of the schools.

Comparison's are based on BCPS and EAI data from FY 1991 through FY 1994. The objectives of the comparisons were:

- To determine EAI's spending priorities for the first year of the TESSERACT program
- To compare EAI's spending practices with those of the previous managers of the EAI schools
- To compare EAI's spending practices with those of the managers of similar BCPS institutions

In order to create reasonable comparisons, data was acquired and cross referenced from numerous sources. Complicating the process were the facts that:

- parallel data between comparison schools and EAI schools was not available for any of the years involved in this study
- while comparison data is derived from proposed budgets, EAI data could only be found fully reported in the form of un-audited actual expenditure reports
- enrollment data was inconsistent among all sources, complicating the process of determining accurate per pupil expenditures
- EAI data was available only for the first year of their involvement with the BCPS

Considering the awkward nature of the data, comparisons were made according to the sources displayed in Appendix B.

Due to the necessity to use an alternative form of reported figures for EAI schools in FY 1993, specific line item comparisons required aggregation of line items to achieve equivalents (i.e. aggregating *Salaries* and *Other Personnel* costs as appears in the site-based budgets to acquire *Salaries and Other Personnel* as appears in the EAI Expenditure Report).

As suggested in Section 3 expenditure per pupil comparisons should be made between schools of similar type (elementary, middle etc.). For spending pattern comparisons, EAI schools were compared with nine non-EAI schools identified by the BCPS Department of Research and Evaluation to be used in performance comparisons by The University of Maryland at Baltimore County. Because the EAI set of schools and the comparison set each included only one middle school, the middle schools were excluded from the majority of the analyses. Peculiarities in per pupil spending in EAI's Harlem Park

Middle School and its counterpart Lombard Middle School will be discussed in the next section.

## **4.0 Results**

### 4.1 The Cost of Education in Baltimore

The findings that follow suggest that allocations to EAI for the management of the nine schools did not accurately reflect educational expenditures throughout the Baltimore City Public Schools. Although Education Alternatives managed what are perceived to be among Baltimore's most difficult schools, each of the institutions are still considered to be primarily *regular education* institutions which cater to a student population ranging only from grades *K - 8* . The assumption that per pupil expenditures for the BCPS could be determined relative to the district total budget and the district total FTE pupils was perhaps oversimplified.

Table 3 displays the difference between actual cost of education in Baltimore's non-EAI schools by grade level and EAI's allowance. The result of this comparison displays that EAI's allowance per pupil is 26% above the district cost for elementary school students and 36% above the district cost for middle school students. Table 4 further illustrates the discrepancy, indicating just how few schools in the city of Baltimore received funding comparable to the EAI schools. At the elementary level, 91% of non-EAI institutions fall below the EAI allowance and at the middle school level 100% fall below the EAI allowance. Of Baltimore's high schools only four exceed EAI's allowance for middle and elementary schools. Whereas each of the EAI schools are classified as regular education institutions, the four high schools that exceed EAI's allocation are small



schools, classified primarily as either special education or alternative education institutions.<sup>8</sup>

**Table 3:** Comparison of average BCPS expenditures per pupil by grade level to EAI expenditures per pupil<sup>9</sup>

| <b>Grade Level</b> | <b>Average Expenditures</b> | <b>EAI Expenditures</b> | <b>Difference (Percent)</b> |
|--------------------|-----------------------------|-------------------------|-----------------------------|
| Elementary         | \$4338                      | \$5474                  | \$1136 (26%)                |
| Middle             | \$4026/3969 <sup>10</sup>   | \$5474                  | \$1448 (36%)                |
| High School        | \$5553/4085                 | -                       | -                           |
| Special            | \$14,488                    | -                       | -                           |

**Table 4:** Summary of BCPS non-EAI school expenditures compared to EAI expenditure levels<sup>11</sup>

| <b>Grade Level</b> | <b>Number Above</b> | <b>Percent Above</b> | <b>Number Below</b> | <b>Percent Below</b> |
|--------------------|---------------------|----------------------|---------------------|----------------------|
| Elementary         | 9                   | 9%                   | 96                  | 91%                  |
| Middle             | 0                   | 0%                   | 24                  | 100%                 |
| High School        | 4 <sup>12</sup>     | 22%                  | 14                  | 78%                  |
| Special            | 8                   | 73%                  | 3                   | 27%                  |

**Table 5** displays a comparison between EAI's current contracted budget with the BCPS and a potential EAI budget determined by using Baltimore's average cost of education by school type. Calculating EAI's allowance by this method would result in a total savings of

<sup>8</sup> The schools exceeding EAI's allocation are the Francis Woods Alternative High School (FTE = 319), Baltimore School for the Arts (294), Venable High School (FTE = 201) and Joseph Briscoe Sr. High (FTE = 202) Source: School Instructional Expenditure Report (Program ID: AABD0007.1)

<sup>9</sup>Clarke, Mary Pat

<sup>10</sup> Second figure represents adjusted mean determined by removal of outlying schools in sample (see charts #2 and #3)

<sup>11</sup>Clarke, Mary Pat

<sup>12</sup> Schools 115, 178, 415 and 451 cater primarily to special student populations

\$4.3 million (21%) to EAI elementary schools and \$1.4 million (26%) to EAI middle schools for the BCPS per year. Conversely, EAI's total losses per year would exceed \$5.7 million. From the Fall of 1994 through the end of the term of the contract the district's total savings would exceed \$17 million.

Table 5: What-if analysis; if EAI were allocated funds according to average expenditures (by school type) for all non-EAI schools.

| <b>Grade Level</b> | <b>FTE (EAI Schools)<sup>13</sup></b> | <b>EAI Average PPE</b> | <b>EAI Total Budget</b> | <b>Non-EAI Average PPE</b> | <b>Revised EAI Budget</b> | <b>\$ Excess (Percent)</b>   |
|--------------------|---------------------------------------|------------------------|-------------------------|----------------------------|---------------------------|------------------------------|
| Elementary         | 3790                                  | \$5474                 | \$20,746,460            | \$4338                     | \$16,441,020              | \$4,305,440<br>(21%)         |
| Middle             | 969                                   | \$5474                 | \$5,304,306             | \$4026                     | \$3,901,194               | \$1,403,112<br>(26%)         |
| <b>Total</b>       | <b>4759</b>                           |                        | <b>\$26,050,766</b>     |                            | <b>\$20,342,214</b>       | <b>\$5,708,552<br/>(22%)</b> |

Among the previously presented concerns over this type of cost comparison is that Education Alternatives endeavored to reform Baltimore's most difficult institutions, and that although these institutions were classified as regular education schools, the needs of their students significantly surpassed those of others in Baltimore.

The comparison of EAI's allocations with the nine schools identified by the BCPS Department of Research and Evaluation yielded similar results. Although these schools were identified by factor analysis to share certain performance and demographic characteristics with the schools currently managed by EAI, Table 6 discloses that the nine schools do not share spending characteristics according to their 1993-1994 site based budgets. Only one of the nine comparison schools (Lakewood Elementary, #86) spent in

excess of the EAI allowance (\$5,739). The average per pupil expenditure level for the comparison schools was \$4,391.

**Table 6:** Summary of Comparison Schools PPE compared with EAI PPE

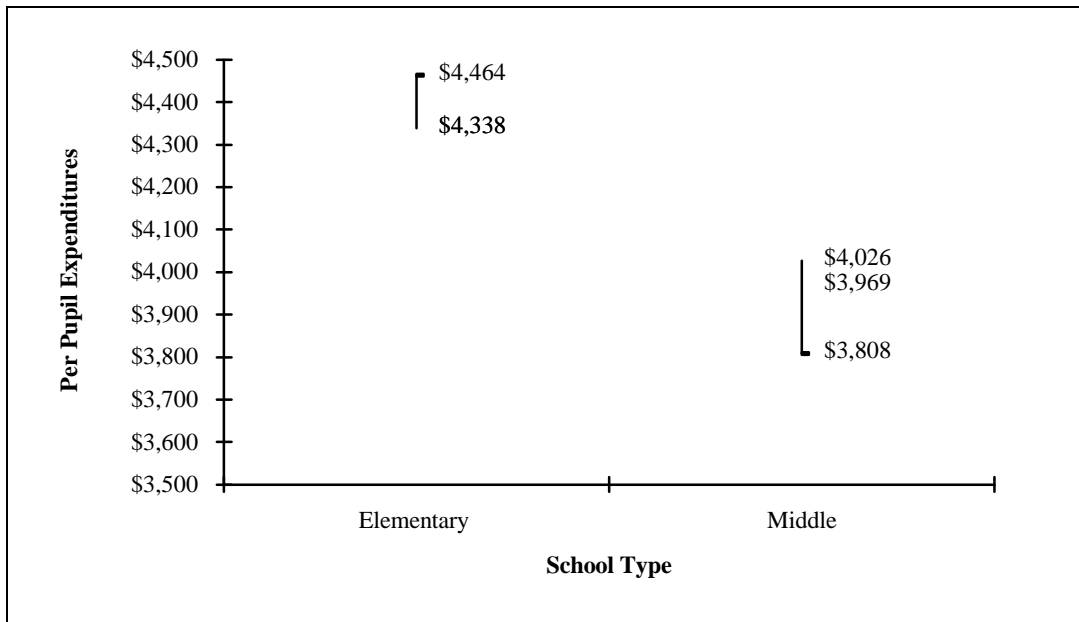
|            | <b>Comparison School PPE</b> | <b>EAI PPE</b> | <b>Percent Above</b> | <b>Percent Below</b> |
|------------|------------------------------|----------------|----------------------|----------------------|
| Elementary | \$4,464                      | \$5,474        | 14%                  | 86%                  |
| Middle     | \$3,808                      | \$5,474        | 0%                   | 100%                 |

Using the previous analyses, a range of possible per pupil expenditures may be generated and applied the eight EAI elementary schools and one middle school (See Figure B) . The middle school high-end expenditure is generated by the average expenditure of all BCPS middle schools (including out-lying data), while the elementary school high-end expenditure is generated by the average of the comparison school expenditures. The low-end expenditure for elementary schools (\$4,338) is the average expenditure level of all elementary schools in the district, while the middle school low-end (\$3,808) is the average expenditure level of EAI's Comparison Middle School.<sup>14</sup>

<sup>13</sup> due to lack of data on actual FTE for EAI schools, FTE values were derived relative to "comparison schools" indicated in the proposal of the Department of Research and Evaluation of the BCPS

<sup>14</sup> Lombard Middle School, #57, Source: School Instructional Expenditure Report (Program ID: AABD0007.1)

**Figure C:** Ranges of per pupil expenditures by school type as generated from each of the previous analyses.



Applying these expenditure levels to EAI schools yields the results seen in [Table 7](#).

The total district savings under these conditions could have been as high as \$5.9 million per year.

**Table 7:** Range of potential excess allocations to EAI annual budget

|                                    | Potential EAI High | Potential EAI Low | Range of Excess Compared to EAI Actual Budget |
|------------------------------------|--------------------|-------------------|---|
| Elementary Schools<br>(FTE = 3790) | \$16,918,560       | \$16,441,020      | \$3,827,900 to<br>\$4,305,440                 |
| Middle Schools<br>(FTE = 969)      | \$3,901,194        | \$3,689,952       | \$1,403,112 to<br>\$1,614,352                 |
| Total                              | \$20,819,754       | \$20,130,972      | \$5,231,012 to<br>\$5,919,792                 |

With three years remaining on the EAI contract as of the Fall of 1994, total savings to the Baltimore City Public Schools through the term of the EAI contract could have been as high as \$17.8 million (See Table 8). Even if the EAI allowance were determined according to the high end of the calculated range, savings would have been approximately \$15.7 million.

Table 8: Possible savings from Fall 1994 through the term of the contract (3yrs).

|                    | <b>Low</b>          | <b>High</b>         |
|--------------------|---------------------|---------------------|
| Elementary Schools | \$11,483,700        | \$12,916,320        |
| Middle Schools     | \$4,209,336         | \$4,843,056         |
| <b>Total</b>       | <b>\$15,693,036</b> | <b>\$17,759,376</b> |

In January of 1995, John Golle of EAI responded to a report by Carl Stokes of the Baltimore City Council. In his report, Stokes had presented similar concerns that EAI had been provided excess expenditures compared with other schools in the district. In Golle's response, however, he affirms that EAI was allocated funds "using the district's existing formula to do so: gross operating dollars from all sources divided by the number of full-time equivalent students (FTE's)."<sup>15</sup> Golle goes on to suggest that since EAI's contract was to include "a disproportionate amount of schools with challenged students", EAI would "not be getting" their "fair share." Unfortunately Golle's statement fails to recognize that there are many students within the district who are "challenged" beyond the capacity of the cities "regular education" institutions, and that the expenditure levels for these pupils (in special schools and out-of-district placements) often exceeds \$20,000 per

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<sup>15</sup>Golle, John. The Myths and Realities of Baltimore's Education Alternatives, Inc. Financial Arrangement. January, 1995

pupil/year. Golle suggests further that most analyses regarding EAI's per pupil expenditures have been performed using a "net to gross comparison." Golle's report indicates that a "gross to gross" comparison would be most appropriate. In the absence of adequate data regarding centralized costs for BCPS institutions, each of the previous analyses have attempted to present a "net to net" comparison. Although, as Golle states "The Sum Cannot Be Greater/Less Than the Parts" it is apparent that the "parts" range widely in their magnitude.

#### 4.2 EAI's Spending Practices

Table 9 displays that while the EAI schools were already experiencing greater growth than their counterparts prior to fiscal year 1993, upon the signing of EAI's contract with the BCPS, the eight EAI elementary schools experienced even greater growth in total budget. BCPS allocations to EAI schools appear to have widened the gap between EAI and non-EAI schools not only in year-to-year dollars, but in the rate of increase as well.

Table 9 also provides a closer look at the changes that have occurred in instructional spending in EAI and comparison elementary schools. Instructional spending in comparison schools shows not only an increase in year-to-year dollars, as previously indicated, but an increase in rate of change over time. This rate of change may be interpreted as an "effort" factor, indicating that the management of the BCPS has significantly increased their instructional efforts in recent years. EAI, on the other hand, has chosen a different approach in spending. Again, the EAI schools were experiencing greater growth than their counterparts prior to fiscal year 1993. The relatively high BCPS

level of effort in the years preceding the EAI contract may be an indication of the special needs of the students in the schools inherited by EAI. In the first year of the EAI contract, however, instructional expenditures experienced negative growth (-7%). Whether this is due in part to discrepancies in the reported forms of the data cannot clearly be determined, yet the differences in spending are significant enough such that minor discrepancies should not dramatically alter the apparent trends. To suggest that this spending practice in EAI elementary schools is a trend at this point in time may be premature. Data for subsequent years of EAI management should be analyzed when made available.

EAI has received much criticism from both the American Federation of Teachers and the Maryland State Department of Education regarding their Special Education spending practices. The majority of the criticism (investigations and lawsuit) has been directed toward spending at the middle school level (in particular, Harlem Park Middle School). An analysis of Special Education spending at the elementary level shows a somewhat different picture. Although it is apparent that EAI Special Education expenditures experienced negative growth in FY 1993 compared to the strong positive growth in the comparison schools, EAI schools had experienced even greater negative growth in special education spending prior to FY 1993. Such spending fluctuations may be due to shifts in district policies regarding placement of special needs children or simply due to general demographic shifts.

Table 9 makes clear EAI's emphasis on spending on operations (particularly facilities maintenance and repair) within the first year of their contract with the BCPS. One possible explanation for the dramatic jump in operations spending is that EAI entered the project with an objective to create a clean and positive learning environment. There is

little question that the facilities inherited by EAI at the outset of the project were in dire need of attention. Another possible explanation for the rise in operations costs arises from the discrepancies in the forms of the reported data. Because all budget items may not be matched on a line for line basis, it is questionable whether EAI, through their contract with the BCPS has chosen to play a more significant role in the operation and maintenance of their facilities. Based on information presented in John Golle's report "The Myths and Realities of Baltimore's Education Alternative's, Inc. Financial Arrangement" it is also possible, however, that the percent increase in operations spending in Table 9 is actually artificially low. Golle indicates that EAI practices "Accrual Accounting" rather than "Cash Accounting". Golle states "Assume BCPS buys a computer. It would show the expenditure during the year of purchase and expense it in its entirety that year. EAI, in comparison, would amortize that expense over five (5) years and show only 1/5 of the total each year as an expense."<sup>16</sup> This practice, though generally accepted in the private sector, may ultimately result in a cumulative effect on increase in operations spending over time. Again, data for subsequent years of EAI management is necessary to determine whether increased operations spending will continue to be a trend over time.

#### 4.3 The Middle Schools and the Special Education Controversy

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<sup>16</sup>Golle, John. The Myths and Realities of Baltimore's Education Alternatives, Inc. Financial Arrangement. January, 1995



Tables 10 and 11 display EAI's spending practices as applied to Harlem Park Middle School. General instructional expenditures for both Harlem Park MS and Lombard MS have steadily increased from FY 1991 to FY 1994. The average rate of change for Harlem Park has been approximately 7.1% (7.3% in FY 1992 and 6.9% in FY 1993). Spending growth in Lombard MS has been somewhat slower at only 3.9% for FY 1992 and 7.7% over the next two years.

Table 10: Differences in per pupil instructional spending between EAI and Comparison middle school

| School         | FY 1991 | FY 1992 | FY 1993 | FY 1994 |
|----------------|---------|---------|---------|---------|
| Lombard MS     | \$2,021 | \$2,100 |         | \$2,262 |
| Harlem Park MS | \$2,182 | \$2,342 | \$2,503 |         |

While increasing spending on General Instruction in Harlem Park Middle School, EAI dramatically decreased Special Education funding, catching the attention of their critics. The prior year increase had been at a rate of 15%. EAI's percent change in Special Education funding was -71% for FY 1993. Over the two year period from FY 1992 to FY 1994 Special Education spending in Lombard Middle School (comparison school) decreased a total of 6.3%. It is also possible that this dramatic shift in special education spending, coupled with the increase in general education funding represent a new EAI philosophy regarding the education of special needs children.

Table 11: Differences in per pupil special instruction spending between EAI and Comparison middle school

| <b>School</b>         | <b>FY 1991</b> | <b>FY 1992</b> | <b>FY 1993</b> | <b>FY 1994</b> |
|-----------------------|----------------|----------------|----------------|----------------|
| <b>Lombard MS</b>     | \$615          | \$630          |                | \$590          |
| <b>Harlem Park MS</b> | \$703          | \$809          | \$234          |                |

## **5.0 Conclusions**

Each of the cost of education comparisons performed indicate that serious discrepancies existed between the actual cost of educating Baltimore's youth, and the allowance provided to Education Alternatives Inc. Implications are that:

- The cost of educating elementary and middle school students in Baltimore is significantly less than the average cost of education for all students in Baltimore.
- The method used for determining “fair contract value” for the EAI allowance was not necessarily appropriate.
- The Baltimore City Public Schools could have achieved substantial savings over the term of the EAI contract had they utilized alternative methods of calculating per pupil allowance.
- The validity of the performance comparisons between EAI schools and the selected comparison schools may be invalidated by spending inequities.

These conclusions suggest that Education Alternatives Inc. was provided with a significant financial advantage in the management of the nine schools. Such an advantage

decreases the district's ability to provide accurate comparative evaluation between the EAI managed schools and comparison schools. It is also important to note that because EAI was responsible for managing only nine of the district's schools, the financial advantage gained by EAI could only have been gained at the expense of other schools within the City of Baltimore.

The internal budget analysis of EAI elementary schools makes clear the fact that EAI's spending practices in the first year of their contract with the BCPS are significantly different from those of either the entire BCPS or the specific schools selected for comparison with the EAI schools. Although questions arise from the analysis of EAI's spending in Harlem Park Middle School, adequate conclusions may not be drawn on a single school basis. Assuming that spending practices reflect the priorities of school managers, the following conclusions may be drawn:

- EAI allocated a greater percentage of its resources to facilities than the BCPS administration.
- EAI allocated a greater percentage of its resources to teacher training (TESSERACT) and technology consulting than the BCPS administration.
- EAI allocated a smaller percentage of resources to general instructional spending than the BCPS administration.

Excluding Harlem Park Middle School, it appears that EAI's special education spending policies do not differ significantly from BCPS policies. Overall, it is difficult, if not impossible to conclude whether or not EAI's first year spending practices are indicative of the future of Baltimore's EAI schools without data from subsequent years of EAI

management. There is also little or no evidence as to whether or not EAI's differentiated spending practices, or their greater overall spending level will have any effect in the future on student outcomes.

## **6.0 Recommendations**

The synthesis of our findings, and our perceptions regarding the role of competitive market practices in education bring us to the following suggestions for both private contractors and public officials in pursuing future ventures:

- Encourage competitive bidding.
- Assess backgrounds, track records, and corporate structure of private providers, including financial stability.
- Do not turn large sums of cash over to private providers who are likely to invest it in ways that are riskier than your district would invest. Rather, schools should invest it themselves and release it as needed to meet obligations.
- Collect good baseline data on student performance and school expenditures in both privately managed schools, a group of control schools and district averages.
- Require private providers to disclose in a timely fashion, both detailed expenditure reports which use line items parallel to those used in the school district and relevant personnel and student data.
- Write sensible contracts that include accountability and performance standards.

- Establish per pupil cost comparisons by school type (e.g., K-6 elementary, 6-8 middle schools, 9-12 high schools, special education schools, alternative schools, and vocational technical schools)

In an untested market, “fair contract value” and quality of service are extremely difficult to define. Where few competitors exist, and track records are not available the best a willing consumer is able to do is to compare provider prices with their own spending track record to determine potential savings. Unfortunately, due to the nature of financial book-keeping in public education, separating the financial reality from the political reality generally becomes a convoluted task. In addition, due to the level of financial expertise of their own personnel, schools are likely to be left at the mercy of the only available provider for determining cost.

Assessment of quality of service would also seem to be vital considering that the product in question is the education of our children. While measures for assessing the quality of transportation contractors are easily defined, the same cannot be said of measuring educational performance. There remains little consensus throughout the field of public education on what measures are most appropriate for assessing institutional performance. Without performance measures, performance contracting cannot succeed. These are the issues that continue to plague the emerging market for providers of more broad based educational services. Until further data is available on EAI as well as other providers our true knowledge of the pros and cons of privatization in education will remain extremely limited.

| <b>Comparison Schools<br/>Per Pupil Spending</b> | FY '91          | FY '92          | FY '93    | FY '94          | Percent Change |            | Avg %Change |
|--|-----------------|-----------------|-----------|-----------------|----------------|------------|-------------|
|  |                 |                 |           |                 | FY'91-'92      | FY'92-'94  | FY'91-'94   |
| Instruction                                      | \$ 2,153        | \$ 2,236        | NA        | \$ 2,924        | 4%             | 31%        | 12%         |
| Special Education                                | \$ 387          | \$ 405          | NA        | \$ 523          | 5%             | 29%        | 11%         |
| Other Instruction                                | \$ 30           | \$ 46           | NA        | \$ 47           | 54%            | 3%         | 19%         |
| Gifted and Talented                              | \$ 31           | \$ 31           | NA        | \$ 36           | -1%            | 16%        | 5%          |
| Instructional Resource                           | \$ 207          | \$ 204          | NA        | \$ 76           | -1%            | -63%       | -21%        |
| Operations/Maintenance                           | \$ 304          | \$ 327          | NA        | \$ 388          | 8%             | 19%        | 9%          |
| Food/Transport                                   | \$ 263          | \$ 294          | NA        | \$ 316          | 12%            | 7%         | 6%          |
| <b>Total</b>                                     | <b>\$ 3,374</b> | <b>\$ 3,543</b> | <b>NA</b> | <b>\$ 4,309</b> | <b>5%</b>      | <b>22%</b> | <b>9%</b>   |

| <b>EAI Schools<br/>Per Pupil Spending</b> | FY '91          | FY '92          | FY '93          | FY '94    | Percent Change |            | Avg %Change |
|---|-----------------|-----------------|-----------------|-----------|----------------|------------|-------------|
|   |                 |                 |                 |           | FY '91-'92     | FY '92-'93 | FY '91-'93  |
| Instruction                               | \$ 2,521        | \$ 2,742        | \$ 2,568        | NA        | 9%             | -6%        | 1%          |
| Special Education                         | \$ 351          | \$ 274          | \$ 250          | NA        | -22%           | -9%        | -15%        |
| Gifted and Talented                       | \$ 35           | \$ 34           | \$ -            | NA        | -2%            | -100%      | -51%        |
| Operations/Maintenance                    | \$ 313          | \$ 340          | \$ 564          | NA        | 9%             | 66%        | 37%         |
| Tesseract (& other Consulting)            | \$ -            | \$ -            | \$ 523          | NA        |                |            |             |
| Project Start-up                          | \$ -            | \$ -            | \$ 277          | NA        |                |            |             |
| Food/Transport                            | \$ 123          | \$ 272          | \$ 289          | NA        | 120%           | 6%         | 63%         |
| <b>Total</b>                              | <b>\$ 3,342</b> | <b>\$ 3,662</b> | <b>\$ 4,471</b> | <b>NA</b> | <b>10%</b>     | <b>22%</b> | <b>16%</b>  |

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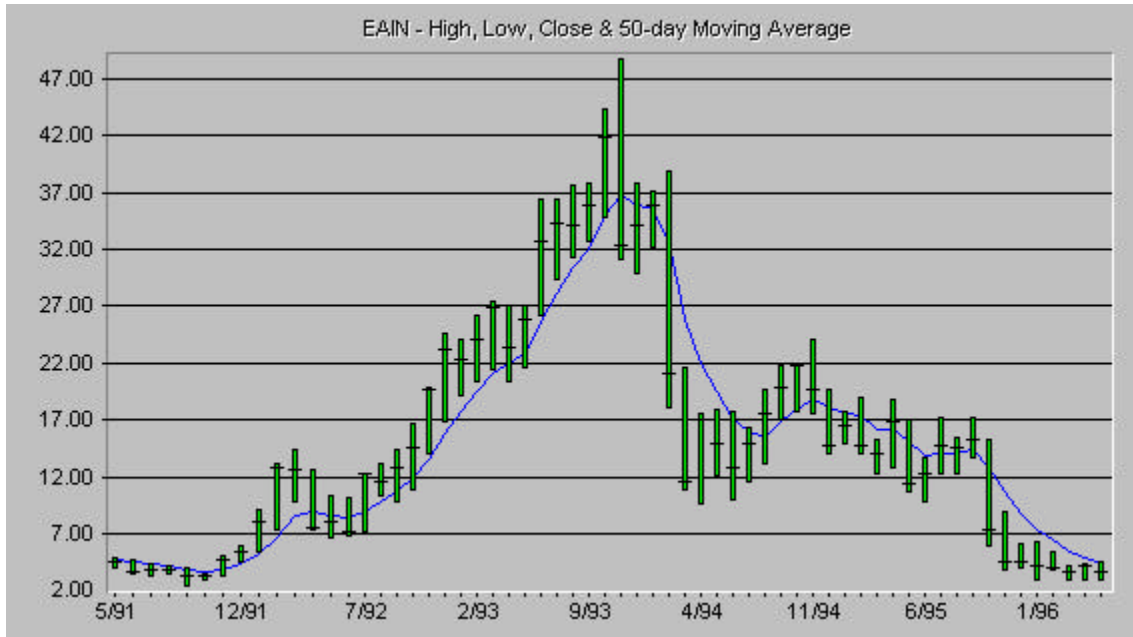
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Appendix A: EAI's stock trends from IPO (May, 1991) through June 1, 1996 (Monthly)



Appendix B: Data sources and the structure of the comparison between EAI schools and their BCPS counterparts.

| <b>Year</b>                            | <b>Comparison Schools</b>   | <b>EAI Schools</b>  |
|--|---|---|
| FY 1991                                | <u>Budgets &amp; Enrollment:</u><br>BCPS Site-based budget book<br>Proposed Budgets | <u>Budgets &amp; Enrollment:</u><br>BCPS Site-based budget book<br>Proposed Budgets   |
| FY 1992                                | <u>Budgets &amp; Enrollment:</u><br>BCPS Site-based budget book<br>Proposed Budgets | <u>Budgets &amp; Enrollment:</u><br>BCPS Site-based budget book<br>Proposed Budgets   |
| FY 1993<br>*First year of EAI contract | <b>Data Not Available</b>   | <u>Budgets:</u> BCPS Expenditure Report no. 200 Un-audited<br><u>Enrollments:</u> BCPS Instructional Expenditure Report for FY 1993 |
| FY 1994                                | <u>Budgets &amp; Enrollment:</u><br>BCPS Site-based budget book<br>Proposed Budgets | <b>Data Not Available</b>   |